

TAX • FEATURES

MHT's McGillicuddy Named For TF's 1984 Public Service Award

Tax Foundation's 36th National Conference will zero in on the two-way squeeze in which the Federal government finds itself, as spending and indebtedness continue to outpace revenues. A cross-section of policy specialists and economists will address various facets of this dilemma during the day-long meeting on December 5 at New York's Plaza Hotel.

Leif H. Olsen, Chairman Economic Policy Committee, Citibank, N.A., will keynote the conference, addressing the topic "Taxpayers versus Tax Spenders: Who's Less Honest?" Murray L. Weidenbaum, Director of the Center for Study of American Business at Washington University and recent Chairman of the President's Council of Economic Advisers, will follow, on the topic of "The Way Out of the Budget Quandary: The Need for Budget Cuts." John E. Chapoton, Partner, Vinson & Elkins, and former Assistant Secretary of the Treasury for Tax Policy, will conclude the morning's session with a talk on "The Evolution of the Tax System and Implications for the Future."

Horace W. Busby, political analyst and former top aide to Lyndon B. Johnson, will take the podium at the conference luncheon. His topic will be "The Politics of Changing Taxes."

The afternoon session of the meeting will be devoted to a "Systematic Review of the Income Tax" by two Price Waterhouse executives: Bernard M. Shapiro, National Director of Tax Policy, and Larry L. Dildine, Director of Tax Economics. Leonard E. Kust, Partner, Cadwalader, Wickersham & Taft, and Herbert J. Lerner, Vice Chairman-Tax Services, Ernst & Whinney, will sum up the conference's deliberations at the end of the day.

Tax Foundation's 47th Annual Dinner will take place that evening, also at The Plaza. John F. McGillicuddy, Chairman of the Board and Chief Executive Officer of Manufacturers Hanover Corporation and Manufacturers Hanover Trust Company, will receive the Foundation's Distinguished Public Service Award for 1984. W. Bruce Thomas, Tax Foundation's Chairman and Vice Chairman-Administration and Chief Financial Officer of U.S. Steel Corporation, will preside and make the presentation.

For further details and reservations, please call (202) 822-9050, or write Tax Foundation, One Thomas Circle, N.W., Suite 500, Washington, D.C. 20005.

Indexing Starts Jan. 1, Low Earners Helped Most

Taxpayers will save about \$8 to \$10 billion on their 1985 tax bills when indexing of the personal income tax system kicks in this January, according to economists at the Tax Foundation. And those in the low- and middle-income levels will benefit the most, they say.

Indexing is much more valuable to lower-income families as a percentage of their tax liability than to the upper-income household. The family with the \$12,000 adjusted gross income sees its tax bill reduced by \$45 - or 8.3 percent due to the increase in the personal exemption and the zero bracket amount. As income rises, the dollar amount of the tax saving also rises, but at a lesser percent of tax paid.

Tax Foundation economists explain that indexing takes the hidden tax of inflation out of the individual income tax system, by wiping out the "fiscal dividend" of inflation-related tax increases.

The reason low- and middle-income taxpayers benefit most is that the personal exemption and the zero bracket amount will be indexed, as well as the rest of the marginal rate brackets. Taxpayers who itemize their deductions will receive no benefit from having the zero bracket amount indexed. Because they reduce their taxable income by the excess of their itemized de-

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Effect of Indexing on Federal Income Tax for Families at Selected Income Levels^a

Tax Year 1985

Adjusted gross income	Amount of tax in 1985 ^b		Reduction in tax with indexing	
	Without indexing	With indexing	Amount	Percent
\$ 12,000	\$ 539	\$ 494	\$ 45	8.3
20,000	1,741	1,682	59	3.4
30,000	3,067	2,983	84	2.7
40,000	5,043	4,901	142	2.8
50,000	7,424	7,198	226	3.0
75,000	14,570	14,249	321	2.2
100,000	22,715	22,295	420	1.8
200,000	59,170	58,464	706	1.2
500,000	172,100	171,327	773	0.4

^aMarried couple with one earner, two children, filing joint return. All income is assumed to be from wages and salaries.

^bAssumes zero bracket amount for the two lowest income levels and itemized deduction for the other brackets at the same percentage of income for each level as in 1981.

Source: Tax Foundation computations based on 1984 data (without indexing) from Department of the Treasury, adjusted by 4.1% increase in the Consumer Price Index from fiscal 1983 to fiscal 1984.

"State-local public monthly payrolls hit \$18.2 billion in October 1983—up \$1 billion from 1982."

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ductions over the zero bracket amount, any gain itemizers realize from an increase in the zero bracket amount is exactly offset by the reduction in excess itemized deduction.

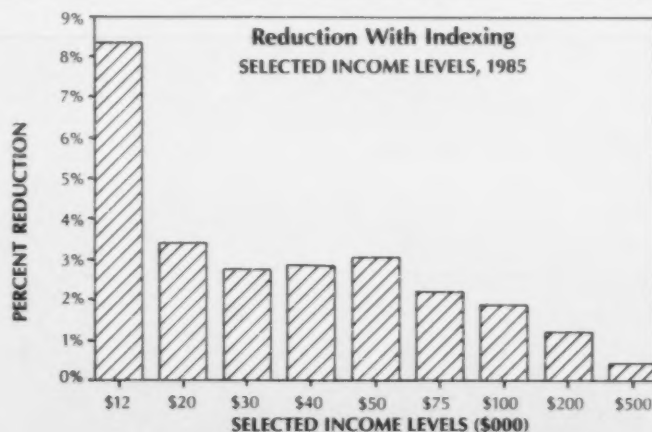
Taxpayers at the upper end of the scale, however, do benefit from the larger personal exemption and wider brackets introduced into the scale. The accompanying table details the reduction in tax liability for selected income levels in 1985. Based on the 4.1 percent increase in the indexing factor, the major changes for 1985 are:

- personal exemption rises from \$1,000 to \$1,040;
- zero bracket amount (formerly the standard deduction) rises from \$3,400 to \$3,540 for married taxpayers and from \$2,300 to \$2,390 for singles.

Introduced as part of the Economic Recovery Tax Act of 1981, indexing automatically adjusts the individual income tax brackets, the zero bracket amount, and the personal exemption for the previous year's rate of inflation. This prevents inflation from shifting taxpayers into higher and higher tax brackets (with successively higher marginal rates).

Indexing was not part of the original tax package promoted by the Reagan Administration nor of the Democratic alternative. It was injected into the bidding war to sway about eight Democratic votes to the President's package. Since 1981 there have been numerous calls to repeal, defer, or modify the automatic adjustment before it actually takes hold on January 1, 1985.

Now that the first measurement period has passed, the withholding tables for wages earned in 1985 can be recalculated, and it is appropriate to review the likely impact of indexing and the policy implications involved. The provision itself is remarkably short and simple. The Department of Treasury must calculate the average percentage increase in the CPI for the year October 1983 through September 1984 over the previous 12-month period. The index numbers are published monthly by the Bureau of Labor Statistics. Multiply the personal exemption and the dollar brackets in the rate tables by that factor to complete the adjustment. This operation removes about 85 percent of the inflation-induced increase in tax revenues.



Indexing is much more valuable to lower-income families as a percentage of their tax liability than to the upper-income household. The family with the \$12,000 adjusted gross income sees its tax bill reduced by \$45 or 8.3 percent due to the increase in the personal exemption and the zero bracket amount. As income rises, the dollar amount of the tax saving also rises, but at a lesser percent of tax paid.

Employment Starts Climb At State-Local Levels After 2-Year Decline

Growth in state-local public employment started up again in 1983 after two years of decline, according to economists at the Tax Foundation. Thirty states plus the District of Columbia recorded more workers on their job rolls. The increase was not impressive, however, as state-local employment, measured in numbers of full-time equivalent employees, crept up by just over half a percentage point. Nationwide in fiscal 1983, 10.88 million employees were on the job versus 10.83 million in the previous year.

This most recent hike follows consecutive decreases for fiscal years 1981 and 1982—the only declines in state-local job rolls recorded since World War II, say Tax Foundation researchers. Except for the 1981-82 recession, state-local employment has risen continuously since the mid-1940s. The all-time record for persons employed by state-local governments goes to 1980, when there were 11.0 million such public employees.

Between 1973 and 1983, non-Federal public employment growth averaged nearly 1.3 percent annually. For every 100 persons employed by states and localities in 1973, over a dozen more had been added to the rolls by 1983, Foundation researchers report, based on analysis of annual data prepared by the Bureau of Census.

State and local government employment also has increased in relation to the population at large. In fiscal 1983 public employees numbered 465 for every 10,000 in the population—up from 456 per 10,000 a decade earlier.

State-local public monthly payrolls hit \$18.2 billion in October 1983—up \$1 billion from 1982. By comparison, state-local payrolls totalled "just" \$8.0 billion in 1973. Between October 1982 and October 1983, these outlays increased 6.2 percent. For the ten-year span since 1973, they averaged 8.6 percent annual growth.

Total growth for the decade just ending (1973-83) showed a 14 percent increase in state-local employees and a 128 percent increase in payrolls.

Average monthly earnings per employee doubled during the decade. For the month of October 1983, state and local governments nationwide paid employees an average \$1,674, up from \$836 in 1973.

Top pay was in Alaska (\$2,746), while Mississippi paid its employees least (\$1,171). After Alaska came the District of Columbia, California, and Michigan

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Tax Features

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State-Local Pension Assets at Record Level

Financial assets held by state and local government pension systems reached a record \$289.7 billion at the end of fiscal year 1983. They grew \$44.5 billion (18.1 percent) that year, Tax Foundation economists report. Because of this and earlier increases, assets of these systems are now almost three times as large as they were in 1975. These holdings account for about 26 percent of the \$1 trillion now salted away in all public and private pension fund holdings in the United States.

Contributions from government employers, employees, and earnings on accumulated assets fund state and local retirement systems. Annual receipts from all sources in fiscal 1983 totaled \$57.9 billion, an increase in \$9 billion (18.3 percent) over 1982. For the 12 months, benefit payments to about 3.1 million retirees and other withdrawals from the funds increased only \$1.5 billion or 8.3 percent.

The size of asset holdings and their investment performance have become increasingly important in financing the systems. From fiscal 1982 to 1983, earnings on the accumulated assets jumped by 38 percent. For the first time such earnings became the major single source of receipts for the pension funds. Investment earnings provided \$26.3 billion to the funds (45.4 percent of the year's receipts). Government employers contributed 39.6 percent, and the 10.4 million active employee members put in only 15.0 percent.

Traditionally, state and local governments—not earnings on investments—have been the primary contributor to the pension funds. In the 1970s government provided between 45 percent and 49 percent of pension funds receipts, while employee contributions ranged from 19 percent to 28 percent of the total. As recently as 1970, investment earnings contributed only 25.0 percent of annual fund receipts.

The 194 systems administered by state governments account for the bulk of the asset holdings of the 2,534

separate systems. The state systems, most of which also include many local employees, hold 79 percent of the financial assets of all systems combined. According to the Bureau of the Census, which compiles annual data, about 95 percent of participants belong to one of the 168 systems with 5,000 or more members. Two-thirds of the total number of plans of state and local governments had fewer than 100 enrolled members at the end of fiscal 1983.

Earnings on investments account for the largest segment of retirement system receipts in 33 of the 50 states. In 14 states they provide 50 percent or more. Government contributions account for the largest segment in the remaining 17 states and the District of Columbia.

As investment portfolios of these pension systems have expanded, their composition has also changed. Today, holdings of corporate bonds, corporate stocks, and Federal securities comprise over three-fourths of the assets.

Corporate bonds make up the largest segment of state-local assets—27.2 percent in fiscal 1983. At the same time, their relative share has declined in recent years, as measured against a share of 40.1 percent in 1962, and 55.1 percent in 1972.

Corporate stocks today account for about one quarter of the dollar value of all assets. Two decades ago they comprised a mere 3 percent of the assets.

Federal securities make up about one quarter of financial assets today, as they did in the early 1960s.

State-local securities have almost dropped off the charts. In 1962, they made up nearly one-fifth of the total. Today they account for less than a single percentage point.

Mortgages have stayed generally around 8 percent to 9 percent of total. About 3 percent of asset value is now in cash and deposits, up from just over 1 percent for most earlier years.

The table below provides further details.

"Earnings on investments account for the largest segment of retirement system receipts in 33 of the 50 states."

(STATE-LOCAL EMPLOYMENT, from page 2)
(\$2,263, \$2,101, and \$1,978, respectively).

Just above Mississippi, the lowest payrolls per employee were recorded for Arkansas, South Carolina, and West Virginia (\$1,220, \$1,305, and \$1,311, respectively).

Payroll per employee in Wyoming rose the most rapidly—up 160.9 percent for the ten-year period. Next were North Dakota (140.0 percent), Alaska (131.2 percent), Utah (130.6 percent), New Mexico (125.2 percent), Montana (124.0 percent), Texas (119.6 percent), and Colorado (119.3 percent).

The lowest growth in payroll per employee was in Hawaii (up 76.0 percent for the decade), followed by New Jersey (up 84.8 percent), Missouri (88.9 percent), Connecticut (91.5 percent), and Pennsylvania (91.7 percent).

Alaska showed the decade's highest growth of the 50 states both in employment levels (up 68.3 percent) and in public payrolls (up 289.2 percent).

For a state-by-state breakdown of state and local government employment and payrolls, month of October 1973 and 1983, please write to the Tax Foundation.

Assets and Annual Receipts of State and Local Employee Retirement Systems by Source
Selected Fiscal Years, 1960-1983
(Millions)

Year	Cash and security holdings	Receipts by source			
		Total	Employee contributions	Government contributions	Earnings on investments
1960	\$ 18,539	\$ 3,393	\$1,140	\$ 1,652	\$ 601
1965	31,814	5,260	1,626	2,418	1,216
1970	54,918	9,848	2,788	4,600	2,460
1971	61,605	11,310	3,159	5,241	2,910
1972	68,760	12,620	3,400	5,750	3,471
1973	78,417	14,878	4,166	6,649	4,064
1974	87,488	16,527	4,207	7,821	4,500
1975	98,064	18,898	4,488	9,116	5,294
1976	111,322	21,037	4,808	10,502	6,327
1977	123,481	25,347	5,233	12,369	7,744
1978	142,637	28,032	5,681	13,660	8,681
1979	161,700	31,949	6,069	15,336	10,544
1980	185,226	37,313	6,466	17,532	13,315
1981	210,427	43,441	7,289	20,020	16,133
1982	245,252	48,961	8,123	21,808	19,030
1983	289,731	57,906	8,699	22,936	26,271

Source: U.S. Department of Commerce, Bureau of the Census; and Tax Foundation computations.

Budget Will Grow For Public Education During Next Decade

"In fiscal 1982, state-local governments shelled out 24.4 cents of their general budget dollars for local public schools."

Rising enrollments and renewed interest in improving public schools over the next decade may alter the recent decline in the share of state-local budgets spent on local public schools, according to Tax Foundation analysts.

The 1984-85 school year will mark the end of a 12-year period of falling enrollments nationwide. Beginning in the fall of 1985, projections of the National Center for Education Statistics (NCES) suggest that enrollments will begin to rise slowly during the remainder of the 1980s, reaching 41,078,000 pupils by the 1992-93 school year.

From school year 1982-83 through school year 1992-93, student enrollments will increase by about 1.4 million (4 percent). During the previous ten years,

they declined by 6.1 million (13 percent). (See accompanying table.) The jump in elementary school attendance (grades K-8) will more than offset expected reductions in secondary grades (9-12). These projections assume that there will be annual increases in the younger school-age population during the period, according to Tax Foundation researchers.

Since the turn of the century, local public schools have been the costliest service provided by state and local governments. In 1983-84 they will cost taxpayers an estimated \$126.9 billion. Despite the vast expansion in other services such as public welfare and higher education, local schools have maintained their claim of between 24 and 30 cents of every dollar spent by these governments. In fiscal 1982 (latest data available), state-local governments shelled out 24.4 cents of their general budget dollars for local public schools. This was nearly 4 cents lower than in 1972 when the share was 27.7 cents of a considerably smaller spending budget.

Between 1972 and 1982, while all other spending by state-local governments rose by 160 percent, local school outlays climbed by 127 percent, even though enrollments fell by 13 percent. (The rise in public school costs during the 1962-1972 decade had been much sharper—163 percent.)

Tax Foundation economists note that the recent moderation in the growth of public school costs mirrors enrollment reductions, placing restraints on current school expenses, coupled with some slowing in the growth of capital spending for school buildings, and in the rate of increases in teachers' salaries.

Enrollments in public elementary and secondary schools peaked in the fall of 1971 at 46,081,000, according to the NCES. Since then, the number of pupils has declined. It is expected to reach a low of around 39,000,000 in the fall of 1984, in tandem with the decline in 5-to-17 year-olds in the population.

Along with rising pupil enrollments, the NCES also foresees a turnaround in the decline in inflation-adjusted teachers' salaries. With the possibility of teacher shortages in the late 1980s, salaries are expected to rise again and return to the higher real levels of the early 1970s.

Trends in Enrollment and Instructional Staff in Public Elementary and Secondary Schools

1972-73 to 1992-93^a

Enrollment/ teachers	Number (thousands)			Percent change	
	1972-73	1982-83	1992-93	1972-73 to 1982-83	1982-83 to 1992-93
Enrollment,					
Total	45,744	39,643	41,078	- 13	+ 4
K-8	31,831	27,143	30,025	- 15	+ 11
9-12	13,913	12,501	11,053	- 10	- 12
Classroom teachers,					
Total	2,103	2,110	2,299	0	+ 9
K-8	1,140	1,165	1,379	+ 2	+ 18
9-12	963	945	920	- 2	- 3

^aProjected

Source: U.S. Department of Education, National Center for Education Statistics; and Tax Foundation computations.



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TAX·FEATURES

6.9% State-Local Tax Growth Marks 2nd Smallest Rise Since 1963

State-local taxes chalked up the smallest gain in four years during fiscal year 1983, as they registered an increase of 6.9 percent over fiscal 1982, Tax Foundation economists report. The \$284.6 billion collected in 1983 topped 1982's tax take by \$18.3 billion.

With the exception of 1979, the 1983 increase in tax collections was the leanest in twenty years. In 1979, the impact of California's Proposition 13 held state-local tax revenues to a 6.1 percent increase. These figures, according to analysts at the Washington-based tax watchdog organization, are for general taxes—all levies except unemployment insurance.

New Flat Tax Proposals Would Reverse U.S. Policy According to New TF Study

The three leading plans for a modified flat income tax—the Treasury Department's November 1984 Report, the Bradley-Gephardt bill and the Kemp-Kasten bill—are analyzed in "Flatter Taxes and Fatter Bases: An Evaluation of Current Proposals," a new special report from the Tax Foundation, Incorporated.

"There is much controversy over the economic impact of these tax reform plans," the 28-page report says, pointing out that all three would curtail severely the capital recovery provisions currently in effect.

The new study focuses principally on the Treasury Department's plan and weighs the two congressional proposals against the Treasury's concepts. Enactment of any of the proposals, it points out, would mark a "drastic reversal of the U.S. industrial tax policy put in place over the last year." The report also charges that Treasury's plan involves a deliberate shifting of the tax burden to the corporate sector.

Significant progress toward tax simplification, which the report defines as both "ease of compliance and for tax/investment planning," would be gained under Treasury's proposal. The price would be "the proposed spread of indexing and new measurements of income in the business sector."

Bradley-Gephardt and Kemp-Kasten offer somewhat less simplification but also contain fewer planning complications. "Both congressional programs are

(Continued on page 2)

While total increases were modest, property and individual income tax collections advanced rather strongly, says the Tax Foundation. Property taxes rose 9.0 percent in fiscal 1983 from the previous year, and individual income taxes increased 8.6 percent. General sales taxes rose 7.1 percent. Corporate income taxes dropped 5.2 percent, and other major tax sources showed relatively small increases.

Not reflected in the record of general tax collections for the year was a sharp hike in unemployment insurance levies paid by business employers, according to Tax Foundation researchers. These taxes jumped from \$15.8 billion in 1982 to \$20.7 billion in 1983, a 31 percent rise, and brought total state-local taxes—general and other—above the \$300 billion mark for the first time. At \$305.3 billion in fiscal 1983, total state-local taxes were \$23.2 billion or 8.2 percent higher than in the previous year.

In contrast to 1983, fiscal 1984 may turn out to be a banner year for state-local tax collectors, according to Foundation analysts. Advance reports from the Bureau of the Census, covering the 12 months ending June 30, 1984, reveal that state-local general taxes alone totaled \$320.5 billion, an increase of \$36.6 billion or 13.7 percent from the same period one year earlier.

Over the last decade, from 1973 to 1983, state-local taxes rose by 135 percent, an annual average of 8.9 percent. State taxes grew at a faster pace than local collections throughout the 1970s. General state taxes increased by \$103.3 billion or 152 percent—from a total of \$68.1 billion in fiscal 1973 to \$171.4 billion in fiscal 1983. At the same time, local taxes rose by \$60.1 billion or 113 percent, from \$53.0 billion in fiscal 1973 to \$113.1 billion in fiscal 1983. As a result of these divergent growth rates, state collections rose from 56 percent of combined state-local taxes in 1973 to 60 percent in 1983.

State-local general taxes averaged \$1,216 per capita in fiscal 1983—twice the \$577 per capita level recorded for 1973. For this same period, though, state-local tax growth lagged behind increases in personal income. Nationwide, general taxes dropped from \$129 per \$1,000 of personal income to \$111 per \$1,000—down

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"State-local
general taxes
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State-Local Tax Collections by State^a
Per Capita and Per \$1,000 of Personal Income
Fiscal Years 1973 and 1983

State	Per capita taxes			State-local taxes per \$1,000 of personal income			
	Amount 1973	Amount 1983	Percent increase	Rank 1983	Amount 1973	Amount 1983	Percent change
U.S. Average	\$577	\$1,216	111	—	\$129	\$111	- 15
Alabama	351	806	129	48	104	94	- 10
Alaska	494	4,908	893	1	98	330	238
Arizona	557	1,064	91	32	138	108	- 22
Arkansas	342	771	125	50	105	92	- 12
California	739	1,337	81	13	149	108	- 27
Colorado	543	1,166	115	23	123	98	- 20
Connecticut	727	1,434	97	8	136	104	- 24
Delaware	586	1,273	117	16	115	109	- 5
Florida	491	968	97	38	119	90	- 24
Georgia	433	973	125	36	112	103	- 8
Hawaii	684	1,457	113	6	141	129	- 9
Idaho	447	875	96	47	121	99	- 18
Illinois	613	1,255	105	17	119	104	- 13
Indiana	470	905	93	44	108	90	- 16
Iowa	530	1,171	121	21	124	109	- 13
Kansas	517	1,129	118	26	117	97	- 18
Kentucky	404	888	120	45	113	101	- 11
Louisiana	449	1,051	134	33	128	105	- 19
Maine	514	1,082	110	31	142	121	- 15
Maryland	629	1,350	115	12	129	111	- 14
Massachusetts	714	1,425	100	10	148	118	- 20
Michigan	635	1,370	116	11	130	125	- 4
Minnesota	650	1,473	127	5	151	132	- 13
Mississippi	382	769	102	51	123	100	- 18
Missouri	473	931	97	41	110	92	- 17
Montana	527	1,179	124	20	132	126	- 5
Nebraska	503	1,146	128	24	117	108	- 7
Nevada	688	1,214	77	19	141	103	- 27
New Hampshire	454	951	110	40	110	89	- 19
New Jersey	631	1,457	131	7	120	112	- 7
New Mexico	438	1,041	138	34	128	117	- 9
New York	894	1,889	111	4	170	153	- 9
North Carolina	425	911	114	43	113	102	- 10
North Dakota	469	1,100	135	28	127	103	- 19
Ohio	475	1,100	131	29	104	103	- 2
Oklahoma	393	1,123	186	27	105	103	- 2
Oregon	533	1,229	131	18	127	119	- 6
Pennsylvania	581	1,169	101	22	130	107	- 18
Rhode Island	542	1,295	139	15	122	120	- 1
South Carolina	391	878	125	46	115	105	- 8
South Dakota	496	914	84	42	135	96	- 29
Tennessee	392	804	105	49	109	91	- 17
Texas	419	1,032	147	35	106	93	- 12
Utah	469	963	105	39	129	113	- 13
Vermont	618	1,138	84	25	168	122	- 28
Virginia	480	1,094	128	30	113	100	- 12
Washington	575	1,306	127	14	128	114	- 11
West Virginia	416	972	134	37	117	112	- 4
Wisconsin	664	1,425	114	9	158	132	- 16
Wyoming	534	2,443	357	2	126	202	60
District of Columbia	664	2,132	221	3	106	145	37

^aExcludes unemployment taxes.

Source: U.S. Department of Commerce, Bureau of the Census; and Tax Foundation computations.

(STATE-LOCAL TAX GROWTH, from page 1)

about 15 percent for the decade.

In 1983, 34 states and the District of Columbia had general taxes in excess of \$1,000 per capita. Alaska ranked highest among the states in per capita state-local taxes (\$4,908), followed by Wyoming (\$2,443), the District of Columbia (\$2,132), New York (\$1,889), Minnesota (\$1,473), Hawaii and New Jersey (\$1,457), and Connecticut (\$1,434).

The lowest taxes per capita in 1983 were recorded for Mississippi (\$769), followed by Arkansas (\$771), Tennessee (\$804), Alabama (\$806), and Idaho (\$875).

Residents of Alaska also experienced the highest increase in collections per capita for the decade—almost a nine-fold advance. The next biggest proportionate increases occurred in Wyoming (357 percent), the District of Columbia (221 percent), Oklahoma (186 percent), Texas (147 percent), Rhode Island (139 percent), and New Mexico (138 percent).

Nevada saw the smallest relative increase of any state—77 percent—followed by California (81 percent), and South Dakota and Vermont (84 percent).

In 1983, the highest state-local general tax burdens per \$1,000 of personal income—next to Alaska's \$330 high—were recorded for Wyoming (\$202), New York (\$153), the District of Columbia (\$145), Minnesota and Wisconsin (\$132), and Hawaii (\$129).

Ranking lowest, by the same measure for 1983, were New Hampshire (\$89), Florida and Indiana (\$90), Tennessee (\$91), and Missouri and Arkansas (\$92).

Decreases in general state-local taxes in relation to personal income were recorded for the decade in 48 states. Of these, 9 showed declines of 20 percent or more. The most noteworthy of these were in South Dakota (a decrease of 29 percent), Vermont (28 percent), and California and Nevada (27 percent).

Increases in taxes relative to income for the decade were registered in Alaska (238 percent), Wyoming (60 percent), and the District of Columbia (37 percent).

The accompanying table provides further details.

(FLAT TAX STUDY, from page 1)

considerably more limited in the reach of their provisions," the report notes.

"The cost of investment capital probably would increase under all these plans," the report says. The full impact of Treasury's proposal is greatly dependent on future inflation rates and expectations as to future inflation.

"No present econometric framework can capture all the trade-offs and interactions of the proposed reforms," the study notes. "The net results for economic efficiency are unknown, and the attendant uncertainties about such a drastic change in industrial tax policy may lead to modification of the reform plans."

While Treasury emphasizes the neutrality of tax treatment between income groups of individuals and among industries and investments in its plan, this drive for "base-broadening neutrality" does not include the entry of political considerations into the proposal. The Tax Foundation analysis lists as political elements the doubling of the personal exemption and retaining of the basic mortgage interest deduction for individuals. It also cites a clash between neutrality and equity in such areas as the proposed elimination of deductions for state-local taxes and in the interaction be-

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Property Taxes Stage Comeback in '83

Property taxes scored gains in the 9 percent range for the third consecutive year in fiscal year 1983, increasing by \$7.3 billion over 1982 levels, according to analysis from the Tax Foundation.

These recent increases appear to have restored property tax trends to their pre-1978 pattern, which was drastically interrupted by California's Proposition 13, according to Tax Foundation economists. Prior to the California tax limitation, property taxes were growing at annual rates averaging 8.7 percent during the 1970s. Between 1977 and 1980, growth dropped to an annual rate of only about 3 percent—for a total three-year increase of less than \$6 billion. From 1980 to 1983, property taxes grew by nearly 30 percent, or \$21 billion.

Property tax growth in recent years has outpaced that of nonproperty taxes imposed by the states and lo-

calities. The difference was especially pronounced in 1983, when the 9.0 percent rise in property taxes was more than 50 percent faster than the 5.9 percent increase in nonproperty state and local levies.

The property tax is the main revenue source for local governments, providing 76 percent of all tax income. Although 43 states impose some type of property tax, the levies generally apply to a narrow base and furnish less than 2 percent of state tax revenues. More than 96 percent of combined state-local property tax revenues go to localities.

Over the past ten years property taxes almost doubled, rising by 97 percent from the \$45.3 billion collected in 1973—an average annual rate of 7.0 percent. Per capita property tax revenues grew by 77 percent, from \$216 in 1973 to \$381 in 1983. During the same period property tax yields in relation to personal income dropped by 28 percent.

(Continued on page 4)

"The property tax is the main revenue source for local governments, providing 76 percent of all tax income."

THE FRONT BURNER

By Robert C. Brown
President
Tax Foundation, Incorporated

"The Assault on Fringes"

Washington taxwriters are gearing up for another assault on fringe benefits. The various tax simplification proposals all address this question, and Senator Bob Packwood, new Chairman of the Senate Finance Committee, detects "a desire to eliminate employer-provided benefits."

This is an odd situation, given the corporate sector's proven ability to deliver an effective and efficient system of health, insurance and retirement benefits at no direct cost to government. But that's not the whole story.

Taxing fringes may parade in the sheep's clothing of equity and fairness, but it is a revenue grab, pure and simple. Treasury estimates that, in 1983, taxing benefits such as employer-paid health and dental insurance, child-care and pensions would have brought in an additional \$70 billion. That's a pile of money, especially in view of Washington's inability to agree on how to cut a mere \$50 billion from the bloated Federal budget for fiscal 1986.

The trouble with this debate is that so much of what is being said is either fallacious or irrelevant.

First off, the entire policy approach rests on the dubious foundation of tax expenditures. If you believe that everything you earn belongs to the government—except for that portion of your earnings Uncle Sam chooses not to take in taxes—then this is your cup of tea.

Secondly, the statistical arguments for this revenue heist indeed prove that you can validate any conclusion at all by manipulating the numbers. The argument runs that 30 to 40 percent of payroll is consumed by fringes. The fine print reveals that most of this is either legally mandated coverage for disability, social security, health and unemployment benefits or such traditional perks as pensions, group insurance, paid vacations, sick leave, and the like. The three basics—group life, group medical and pensions—comprise only about 12 percent to 14 per-

cent of such payroll costs.

Finally, we are told that only the "fat cats" benefit from fringes. In fact, 90 percent of employees over 25 with one year of service are covered by health and life benefits; more than 70 percent have pension plans. In short, most "tax free" benefits accrue to the middle class. Indeed, they are one of the few breaks the U.S. worker receives in the tax code.

Maybe tax-exempt fringe benefits should be examined. Maybe all attempts to manipulate social policy through tax legislation need a second look. But let's approach the task honestly. Let's skip the self-righteous cant of fairness which is laid like a veneer over public-sector greed. And let's remove the debate from the current scramble for revenues to ward off the need to make politically painful budget cuts.

Tax action from 1982 to 1984 shows how much damage can be done to rational policy-making in the name of deficit reduction. Let's not repeat that mistake again this year.

"Taxing fringes may parade in the sheep's clothing of equity and fairness, but it is a revenue grab, pure and simple."

HELL'S ANGEL!



(PROPERTY TAXES, from page 3)

State-by-state trends in property taxes for the 1973-1983 period, both per capita and per \$1,000 of personal income, appear in the table below, along with the 1983 rankings. Some highlights:

- On a per capita basis for 1983, Wyoming (with collections of \$1,007 per person) and Alaska (\$838) far outdistanced any other state. The next highest states were New Jersey (\$635), Connecticut (\$617), New York (\$609), and New Hampshire (\$604). Alabama ranked lowest in per capita property tax collections (\$99), followed by New Mexico (\$144), Louisiana (\$147), Kentucky (\$160), Arkansas (\$162), and Mississippi (\$165).
- In terms of the decade's percentage growth in per capita property taxes, Alaska and Wyoming also

Property Tax Collections by State
Per Capita and Per \$1,000 of Personal Income
Fiscal Years 1973 and 1983

State	Per capita property tax				Property taxes per \$1,000 of personal income			
	Amount	Percent change	Rank		Amount	Percent change	Rank	
	1973	1983	1983		1973	1983	1983	
U.S. Average	\$216	\$ 381	77	—	\$48	\$35	-28	—
Alabama	46	99	114	51	14	12	-16	51
Alaska	126	838	566	2	25	56	127	4
Arizona	211	316	49	31	52	32	-39	27
Arkansas	79	162	106	47	24	19	-20	45
California	348	347	(a)	27	70	28	-60	35
Colorado	218	408	87	21	49	34	-30	23
Connecticut	353	617	75	4	66	45	-32	14
Delaware	104	187	79	44	20	16	-22	49
Florida	143	332	132	28	35	31	-10	29
Georgia	126	266	111	36	33	28	-14	34
Hawaii	127	269	111	35	26	24	-10	40
Idaho	152	238	56	38	41	27	-34	36
Illinois	244	477	95	14	47	40	-17	19
Indiana	236	313	33	33	54	31	-42	28
Iowa	232	469	102	16	54	43	-20	15
Kansas	245	446	82	18	56	38	-31	20
Kentucky	78	160	105	48	22	18	-17	46
Louisiana	79	147	86	49	23	15	-35	50
Maine	223	409	84	20	62	46	-26	12
Maryland	196	354	80	26	40	29	-28	32
Massachusetts	358	523	46	12	74	43	-42	16
Michigan	234	571	144	8	48	52	8	5
Minnesota	221	413	87	19	51	37	-28	21
Mississippi	85	165	95	46	27	22	-21	42
Missouri	163	244	50	37	38	24	-37	38
Montana	267	560	110	9	67	60	-11	2
Nebraska	237	476	100	15	55	45	-19	13
Nevada	236	234	- 1	39	48	20	-59	44
New Hampshire	259	604	133	6	63	57	-9	3
New Jersey	348	635	82	3	67	49	-27	10
New Mexico	91	144	59	50	26	16	-39	48
New York	320	609	90	5	61	49	-19	8
North Carolina	100	213	113	41	27	24	-11	39
North Dakota	183	318	74	30	50	30	-40	30
Ohio	186	355	91	25	41	33	-19	25
Oklahoma	104	189	81	43	28	17	-38	47
Oregon	255	507	98	13	61	49	-19	9
Pennsylvania	153	314	105	32	34	29	-16	33
Rhode Island	218	537	146	10	49	50	2	6
South Carolina	84	215	157	40	25	26	5	37
South Dakota	256	389	52	22	70	41	-41	17
Tennessee	103	206	100	42	29	23	-19	41
Texas	161	381	137	23	41	34	-16	22
Utah	146	281	92	34	40	33	-18	26
Vermont	236	452	91	17	64	48	-25	11
Virginia	130	324	149	29	31	30	-3	31
Washington	198	379	91	24	44	33	-25	24
West Virginia	83	180	117	45	23	21	-11	43
Wisconsin	272	536	97	11	65	50	-23	7
Wyoming	247	1,007	307	1	58	83	43	1
District of Columbia	191	588	209	7	30	40	31	18

*Less than .05 percent.

Source: U.S. Department of Commerce, Bureau of the Census; and Tax Foundation computations.

headed the list, followed by the District of Columbia, South Carolina, and Virginia. Altogether, 22 of the 51 jurisdictions reported a doubling or more in per capita property taxes for the decade. Reductions occurred only in Nevada (-9 percent) and California (-3 percent).

- Property taxes per \$1,000 of state personal income were highest in Wyoming (\$83), followed by Montana (\$60), New Hampshire (\$57), Alaska (\$56), Michigan (\$52), and Wisconsin and Rhode Island (\$50). The lowest property tax burdens in relation to personal income were recorded for Alabama (\$12), Louisiana (\$15), Delaware and New Mexico (\$16), Oklahoma (\$17), and Kentucky (\$18).
- Only five states and the District of Columbia showed any discernible growth in property taxes compared to personal income during the 1973-1983 period. They were: Alaska (up 127 percent), Wyoming (43 percent), the District of Columbia (31 percent), Michigan (8 percent), South Carolina (5 percent), and Rhode Island (2 percent). The sharpest reductions in the property tax to personal income ratio took place in California (down 60 percent), Nevada (59 percent), Massachusetts and Indiana (42 percent), South Dakota (41 percent), North Dakota (40 percent), Arizona and New Mexico (39 percent), and Oklahoma (38 percent).

(FLAT TAX STUDY, from page 2)

tween proposed treatment of capital gains and state income taxes.

On the doubling of the personal exemption, the report notes: "Raising the personal exemption to \$2,000 would certainly be a popular attraction. It also has a weak link to neutrality of treatment and would be very expensive. Interestingly, of the myriads of revenue estimates provided by the Treasury for all kinds of changes from the breathtaking to the merely nit-picking, none is provided separately for the cost of doubling the personal exemption and increasing the zero bracket amount—even though these are among the easiest to estimate. Instead, their cost is lumped in with the effect of the marginal rate reductions totaling some \$132 billion by 1990, of which the increased allowances must account for a substantial portion."

The fate of tax simplification in the 99th Congress remains "very much up for grabs," the report maintains. "It's far from certain that any such effort will be made even though there is a strong public interest in and desire for tax simplification and reform."

Those who seek to keep tax reform and deficit reduction on separate tracks "must succeed," the report argues, "for any real reform to have a chance."

"Flatter Taxes and Fatter Bases: An Evaluation of Current Proposals" is available from the Tax Foundation. See accompanying display box for details.

"Flatter Taxes and Fatter Bases: An Evaluation of Current Proposals," a Tax Foundation Special Report, 28 pp. 1985. Price: \$7.50 members; \$10.00 non-members; plus \$1.00 postage and handling. Order from:

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TAX·FEATURES

Tax Action in '82-'84 Has Halved Tax Cuts Promised for '85 by ERTA

Federal tax law changes taking effect since 1981 have pared the tax cuts promised for 1985 by the Economic Recovery Tax Act of 1981 (ERTA) to about half their original size, according to Tax Foundation analysis.

Under the tax rates and structure in effect on January 1, 1981, Federal receipts in fiscal year 1985 would have amounted to \$821.3 billion. ERTA reduced that by \$168.5 billion, just over 20 percent. Because of other legislation, however, actual receipts are now estimated at \$736.9 billion, a reduction of only 10 percent from what the pre-1981 tax structure would have yielded. Instead of \$168.5 billion in savings offered by ERTA, net

tax savings will be \$84.4 billion—half as much.

These revenue changes mirror the effects of the seven major tax bills enacted from 1981 through 1984, together with increases in social security taxes scheduled under pre-1981 legislation.

ERTA's main provisions reduced 1985 individual income taxes by 132.8 billion (including savings incentives), corporate income taxes by \$31.1 billion, and estate and gift taxes by \$4.7 billion at 1985 levels of economic activity.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) took back \$40.7 billion of the intended 1985 cuts under ERTA by a series of measures tightening up on compliance and collection, removing "unintended benefits and obsolete incentives," and raising excise taxes and employment levies. TEFRA added \$12.4 billion to 1985 individual income tax burdens, \$19.3 billion to corporate income taxes, \$5.4 billion to excise

(Continued on page 6)

Sales Tax Revenues Single Biggest Source Of Funds for States

Sales taxes are the single most productive revenue raisers for state governments, according to recent analysis by the Tax Foundation, Incorporated. Economists at the Washington-based tax watchdog organization say that general sales taxes, which are levied by 45 states, brought in \$53.6 billion to state treasuries in fiscal year 1983—nearly one-third (31.3 percent) of all state tax collections that year.

Connecticut led the list for top rates with its 7.5 percent sales and use tax rate, followed by: Washington (6.5 percent); Minnesota, Mississippi, New Jersey, Pennsylvania, and Rhode Island (6 percent); and Nevada (5.75 percent). No state general sales tax is levied in Alaska, Delaware, Montana, New Hampshire, or Oregon, although municipalities in Alaska do impose sales tax.

Lowest State Sales Taxes

The lowest state sales tax rate of 3 percent is levied in seven states: Colorado, Georgia, Kansas, North Carolina, Oklahoma, Virginia, and Wyoming. (Oklahoma's sales tax will revert to 2 percent on January 1, 1986.) Localities in 29 states levy sales taxes, generally in addition to those shown in the accompanying table. New York City and Yonkers, New York, with a combined state-local rate of 8.25 percent are the highest in the nation.

(Continued on page 2)

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Comparison of Estimated 1985 Federal Tax Receipts under Tax Rates and Structure in Effect on January 1, 1981 and January 1, 1985

	Billions
1985 receipts under January 1, 1981 tax rates and structure	\$ 821.3
1985 receipts under January 1, 1985 tax rates and structure	736.9
Net reduction due to changes in law	- 84.4
Statutory basis for change:	
Economic Recovery Tax Act of 1981	- 168.5
Tax Equity and Fiscal Responsibility Act of 1982 ..	+ 40.7
Highway Revenue Act of 1982	+ 4.4
Social Security Amendments of 1983	+ 9.3
Interest and Dividends Compliance Act of 1983 ..	- 2.4
Railroad Retirement Act of 1983	+ 0.7
Deficit Reduction Act of 1984	+ 9.3
Automatic increases in social security tax base under prior law ^a	+ 12.0
Increases in social security tax rate under prior law ^b	+ 10.0
Exhibit: ERTA effects	- 168.5
Net increases, 1982-1984	+ 84.1
Net reduction 1981-1985	- 84.4

^aJanuary 1 of 1982, 1983, 1984, and 1985.

^bJanuary 1 of 1982, 1984, and 1985—less amount attributed to 1983 social security law above.

Source: Office of Management and Budget.

"Sales taxes are the single most productive revenue raisers for state governments."

(SALES TAX REVENUES, from page 1)

Personal income taxes ranked second as revenue raisers, bringing in \$49.8 billion in fiscal 1983 for 29.1 percent of total tax receipts. Corporate income taxes, the third largest single tax source, amounted to \$13.2 billion, 7.7 percent of the total. Only five states (Ne-

vada, South Dakota, Texas, Washington, and Wyoming) have neither a corporate nor a personal income tax, and only seven states (the previous five plus Alaska and Florida) have no individual income tax.

Major Taxes and Rates Used by States As of January 1, 1985

State	Income taxes		General sales and use tax	Gasoline tax (per gallon)	Cigarette tax (per pack of 20)	Property tax
	Corporation	Individual				
Alabama.....	5% (F)	2 to 5% (F)	4% ^a	11¢	16.5¢	X
Arizona.....	2.5 to 10.5 (F)	2 to 8 (F)	5 ^a	13	15	X
Arkansas.....	1 to 6	1 to 7	4 ^a	9.5	21	X
California.....	9.6	1 to 11	4.75 ^a	9	10	X
Colorado.....	5 ^b	3 to 8 (F)	3 ^a	12	15 ^b	X
Connecticut.....	11.5 ^c	6 to 13 ^d	7.5	15 ^e	26	X
Georgia.....	6	1 to 6	3 ^a	7.5 + 3% of retail	12	X
Hawaii.....	5.85 to 6.435	2.25 to 11	4	12.5 to 16	40% wholesale	
Idaho.....	7.7	2 to 7.5	4	14.5	9.1	X
Illinois.....	4	2.5	5 ^a	12 ^e	12	X
Indiana.....	3 ^f	3	5	11.1	10.5	X
Iowa.....	6 to 12 (F)	.5 to 13 (F)	4	13	18	X
Kansas.....	4.5 ^h	2 to 9 (F ^h)	3 ^a	11	16	X
Kentucky.....	3 to 6	2 to 6 (F ^h)	5 ^a	10 ⁱ	3	X
Louisiana.....	4 to 8 (F)	2 to 6 (F)	4 ^a	16	16	X
Maine.....	3.5 to 8.93	1 to 10	5	14	20 ^j	X
Maryland.....	7	2 to 5	5	13.5 ⁱ	13	X
Massachusetts.....	8.33 ⁱ	5 ^k	5	11	26	X
Michigan.....	2.35	5.35 ^h	4	15	21	X
Minnesota.....	6 to 12	1.6 to 16 (F)	6 ^a	17	18	X
Mississippi.....	3 to 5	3 to 5	6	9	11	X
Missouri.....	5 (F)	1.5 to 6 (F)	4.125 ^{a, k}	7	13	X
Nebraska.....	4.75 to 6.65	19% of Federal income tax	3.5 ^a	14.9	18	X
New Jersey.....	9 ⁱ	2 to 3.5	6	8	25	X
New Mexico.....	4.8 to 7.2	.7 to 7.8 ^m	3.75 ^a	11	12	X
New York.....	10 ⁱ	2 to 14	4 ^a	8	21 ^h	X
North Carolina.....	6	3 to 7	3 ^a	12	2	X
North Dakota.....	3 to 10.5 (F)	2 to 9 ^{h, n} (F)	4	13	18	X
Ohio.....	5.1 to 9.2	.95 to 9.5	5 ^a	12	14	X
Oklahoma.....	4	.5 to 6 ^m (F)	3 ^{a, h}	9	18	X
Pennsylvania.....	9.5	2.35	6 ^a	12	18	X
Rhode Island.....	8 ⁱ	24.9% of Federal income tax	6	13 ⁱ	23	X
South Carolina.....	6	2 to 7 (F)	5	13	7	X
Tennessee.....	6	6 ^d	5.5 ^{a, h}	9	13	X
Utah.....	5	2.25 to 7.75 (F)	4.625 ^{a, h}	14	12	X
Vermont.....	6 to 3 ^h	26.5% of Federal income tax	4 ^h	13	17	X
Virginia.....	6	2 to 5.75	3 ^a	11	2.5	X
West Virginia.....	6 to 7 ⁿ	2.1 to 13	5	10.5	17	X
Wisconsin.....	7.9	3.4 to 7	5 ^a	16	25	X
Florida.....	5		5 ^a	4	21	X
Nevada.....			5.75 ^a	10.25	15 ^h	X
South Dakota.....	These 5 states have no corporate income tax	These 7 states have no individual income tax	4 ^a	13	15	
Texas.....			4.125 ^a	10	19.5 ^e	
Washington.....			6.5 ^a	18	23	X
Wyoming.....			3 ^a	8	8	X
Alaska.....	1 to 9.4	These 5 states have no general sales tax		8	8	X
Delaware.....	8.7	1.3 to 10.7 (F)	5 states	11	14	X
Montana.....	6.75 ^m	2 to 11 (F)	have no	15	16	X
New Hampshire.....	8 ^h	5 ^d	general sales tax	14	17	X
Oregon.....	7.5	4 to 10 (F)		10	19 ^h	X

(X) Indicates state levies a property tax.
(F) Allows Federal income tax as a deduction.

^aLocal taxes are additional.

^bFuture reduction scheduled under current law.

^cAlternative methods of calculation may be required.

^dIn Connecticut, New Hampshire, and Tennessee, tax applies to income from intangibles only, at various rates according to type.

^eFuture increases scheduled under current law.

^fTax is 3% of adjusted gross income. A supplemental net income tax is imposed at 4%.

^gA 2 1/4% surtax is imposed on taxable income in excess of \$25,000.

^hDeductions limited.

ⁱTax imposed at percent of wholesale value.

^jAdditional 14% surtax is imposed.

^kTax of 10% on income derived from intangibles, and 5% on all other income, and an additional 7.5% tax.

^lAdditional tax on net worth is part of the corporate franchise tax.

^mQualified taxpayers may elect to pay alternative taxes at varying rates.

ⁿOptional tax of 7.5% of taxpayer's adjusted Federal income tax liability.

^oFrom January 1, 1983 through June 30, 1985, a 15% surtax is imposed.

^pSurtax of 13.5% is imposed.

Source: Compiled by Tax Foundation from data reported by Commerce Clearing House.

Top Individual Rates

Top individual rates prevail in Minnesota (16 percent); New York (14 percent); Connecticut (on a limited base), Iowa, and West Virginia (13 percent). Income tax rate schedules are progressive (i.e., rise as income brackets go up) in all but five states. Illinois, Indiana, Massachusetts, Michigan, and Pennsylvania apply a flat rate, regardless of income level. In three states, income taxes are levied as a percentage of Federal individual income tax obligations—Nebraska, Rhode Island, and Vermont. The maximum corporate income tax rates are highest in Iowa and Minnesota (12 percent); Connecticut (11.5 percent); Arizona and North Dakota (10.5 percent); and New York (10 percent).

Gasoline Taxes

All 50 states tax gasoline, with the highest rates prevailing in Washington (18 cents); Minnesota (17 cents); Louisiana and Wisconsin (16 cents); Connecticut, Michigan, and Montana (15 cents); and Hawaii (where combined state-local rates range from 12.5 to 16 cents per gallon). Florida (4 cents); Missouri (7 cents); Alaska, New Jersey, New York, and Wyoming (8 cents) place the lowest levies on gasoline. The motor fuels taxes in Georgia, Kentucky, Maryland, and Rhode Island are levied at specific percentages of the wholesale or retail selling price of the product. In addition, some states also tax motor fuels under the states' general sales tax. In fiscal 1983, the states collected \$10.8 billion, 6.3 percent of their total taxes, from motor fuel levies.

Cigarette taxes are another important source of state tax revenues. In fiscal 1983, the states collected \$4.0 billion, 2.3 percent of their total taxes, from tobacco products excises.

All states have local property taxes, and 43 have state property taxes; 39 states have both general sales and income taxes; and 32 states have general sales, income, and property taxes.

The accompanying table gives further details, as of January 1, 1985, for major taxes and rates prevailing in the states.

MARK YOUR CALENDAR

Tax Foundation's 37th National Conference and 48th Annual Dinner will be held this year on **Wednesday, December 4, 1985**, at a new location—the **Waldorf-Astoria Hotel** in New York City. Details will be announced in future issues of *Tax Features*.

Fringe Benefits Loom as Major Target For Revenue Hungry Uncle Sam in 1985

A new act is starting in a long-running tax melodrama starring the Internal Revenue Service in hot pursuit of fringe benefits—those employer contributions to pensions, medical and insurance plans, free parking, company cars, employee discounts and dozens of other supplements to cash pay that have largely escaped the Federal income tax up to now. Free tickets from airlines' "Frequent Flyers" programs are the latest IRS target.

As this report went to press in the Spring of 1985, legislation aimed at taxing still more benefits was beginning to move through the legislative process in Congress. The general opinion was that fringe benefits increasingly will be subjected to income tax as time goes on. But that is not a certainty. Opinion polls show a large majority of voters oppose taxing of benefits, with many preferring higher income tax rates over taxes on fringes—if that choice has to be made.

Billions at Stake

Multi-billions of dollars are at stake in this issue, and anyone who cares about his/her Federal tax burden should be aware that taxation of fringes can turn into a tax collector's dream and a taxpayer's nightmare in the late 1980s and 1990s. One reason is that if the "fair market value" of a benefit such as free parking becomes subject to income tax, that amount of value would then be subject also to social security and unemployment taxes, Federal income tax withholding and probably state and local income taxes.

The chart below hints at the other side of the story, the need to "protect the revenue base" as government tax experts put it. The record is clear that fringe benefits have proliferated far beyond anyone's expectation. The U.S. Treasury and its tax collecting arm, the IRS, fear that more and more compensation for workers and executives will be designed as fringe benefits in the years ahead, thus reducing the dollars subject to income tax and social security/unemployment tax, thereby shrinking the revenue available for supporting

general government including social security. For example, excluding health and pension contributions for taxable income lowers income tax collections an estimated \$80 billion a year.

History shows the benefits-tax issue has been a dilemma for Congress and tax collectors from the earliest days of the modern income tax. But it was only after income tax rates zoomed to a top of 90 percent for a while in World War II that fringes really flowered. Big unions joined in the flight away from taxable income into non-taxable forms of compensation. Demands for fringes became as important as cash wage increases in labor contract negotiations. Executive perks blossomed, with tax-deferred compensation the centerpiece. And Congress led the parade in seeing to it that its Members, their staffs, and other Federal employees got their share of untaxed pay.

Taxing Social Security Benefits

Now a rollback in the tide of tax-free or tax-deferred income is well underway. One significant move came in Spring, 1983, when—in the name of a fiscal rescue for a nearly insolvent social security system—Congress applied the income tax to part of the benefits received by social security pensioners whose total incomes are above \$25,000 for singles, \$32,000 for a married couple, starting in 1984.

Social security benefits are not usually thought of as "fringes" since the system is supported by increasingly heavy payroll taxes on both employers and employees. But the tax-free status of those benefits from their beginning in the late 1930s until 1983 was the leading example of income (in the form of social security benefits) resulting from personal services that had been protected from the income tax. Partial withdrawal of that protection beginning in 1984 showed the trend to "broadening the revenue base" which has become the rallying cry for "tax reform" in the 1980s.

(Continued on page 4)

"Anyone who cares about his/her Federal tax burden should be aware that taxation of fringes can turn into a tax collector's dream and a taxpayer's nightmare in the 1980s and 1990s."

The Flowering of Fringes

Nobody knows the value in current dollars of all fringe benefits now built into the U.S. pay system. But the upward trend can be seen in the growth of four major fringes—

	Employer contributions (millions of \$)				Percentage of all wages and salaries			
	1952	1962	1972	1983	1952	1962	1972	1983
Pensions and profit sharing	\$2,543	\$5,442	\$17,903	\$64,821	1.7%	2.3%	3.6%	4.9%
Group health insurance . . .	1,115	4,188	16,163	81,999	0.7%	1.7%	3.2%	6.2%
Group life insurance	361	1,219	3,573	7,592	0.2%	0.5%	0.7%	0.6%
Workmen's-compensation insurance	1,030	1,745	4,406	15,878	0.7%	0.7%	0.9%	1.2%
TOTAL	\$5,049	\$12,594	\$42,045	\$170,290	3.3%	5.2%	8.5%	12.8%

Note: Data for private sector. Government employees are covered by separate pay and fringes systems.

Source: U.S. Dept. of Commerce, *National Income and Product Accounts, 1929-76 Statistical Tables*, September, 1981; *Survey of Current Business*, July, 1984.

(FRINGE BENEFITS, from page 3)

Targets for '85

At the time of this report, in early Spring, 1985, Congress was just beginning what promised to be a long and heated battle over virtually all tax policies, including fringe benefit issues.

The Treasury Department's Tax Reform Report to the President, issued in November 1984, was the kickoff. It proposed a simplified tax setup featuring fewer and lower income tax rates with fewer deductions and credits.

On fringes, the Treasury proposed a cap of \$70 a month for singles, \$175 for families, on tax-free premiums paid by employers for health insurance benefits; repeal of tax exclusion for group term life insurance (already taxable above \$50,000 policy amount) and unemployment pay (now taxable when income exceeds \$18,000 for joint returns, \$12,000 for singles); repeal of special tax breaks for education benefits, legal services, dependent care, "cafeteria" plans (flexible benefits chosen by employees from a menu offered by their employers).

Other tax reform measures before Congress would wipe out tax protection for most benefits or reduce the limit on the amount sheltered from tax. The Bradley-

Gephardt "flat" tax plan would tax employer-paid health and life insurance premiums as income, and lower the limits on tax-deferred pension contributions and benefits by one-third. The Kemp-Kasten "fair" plan leaves pensions, health and life insurance benefits in place but taxes others, including social security payments.

Uncertain Outcome

What Congress actually will do is uncertain. One possibility is an overall limit, or cap, on the value of the total benefits that can be tax-free for any one person. A pressing practical dilemma is how to measure, fairly and accurately, the market value of many benefits such as commuting (van pooling) aid and child care help, for instance.

Writing statutory language to accomplish that is a daunting task. The alternative is to leave it to the IRS to determine, through its regulations and the often arbitrary decisions of individual agents, what is "qualified" for tax favors and what the "fair market value" of a benefit should be. If that alternative is adopted, as it probably will be, the confusion, uncertainty and frequent unfairness that has marked tax administration in the fringe benefits area will continue apace—as it has for more than 70 years.

"What Congress actually will do is uncertain. One possibility is an overall limit, or cap, on the value of the total benefits that can be tax-free for any one person."

Tax Collectors vs Fringe Benefits: A 70-Year Chase

In the Beginning . . .

Congress adopted the income tax in September, 1913, imposing a 1 percent base tax on taxable income above \$4,000 a year plus an additional tax starting at 1 percent on \$20,000 and progressing up to the maximum of 6 percent on income over \$500,000. The tax applied to "gains, profits, and income derived from salaries, wages, or compensation for personal services . . . derived from any source. . . ."

"Include Me Out . . ."

Scrambling to avoid the tax began at once. A constitutional challenge was settled when the Supreme Court held the tax had been authorized by the 16th Amendment, ratified in February 1913. But court and congressional wrangles over income tax details have never stopped, often centering on disputes over the exact definition of "income subject to tax." Noncash compensation, now called fringe benefits, raised its

head early in the tax chase, and the Internal Revenue Service of that period gave its blessing to the idea that some forms of compensation were nontaxable—much to the regret of later tax collectors.

The Grandfathers . . .

The first of all fringe benefits apparently was reimbursement for supper when paid to an employee working overtime for the convenience of the employer. That was ruled to be "not income" for tax purposes by the IRS in 1920. In 1921, railroad passes issued to railroad employees were determined by the IRS to be "gifts" and thus not taxable income. The modern descendants of those first fringes now include free parking at the workplace, airline and bus passes to employees, subsidized cafeterias, daycare centers, recreational facilities, free trips to conventions for workers and their families, price discounts, company cars and trucks, free financial counseling and legal services, etc., etc. As benefits multiplied, so did confusion over their tax status. New laws from Congress, new regulations from the IRS, flowed out of Washington in an unending stream. IRS agents applied the laws and rules with baffling inconsistency. Courts frequently disagreed with the IRS, and each other.

Statutory Exemptions. . .

Rising controversy led to adoption of the first Internal Revenue Code in 1939, restating and cleaning up the body of tax law developed up to then. A revised Code was adopted in 1954, reflecting changes since 1939. Section 61 of the Code provides that gross income includes income in any form, and the Supreme Court

(Continued on page 8)

Tax Features

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Localities Outpace States and Washington In Raising Own-Source Tax/Nontax Revenues

Local government is a growth industry, if recent trends in both tax and nontax revenue raised by the localities mean anything. Recent analysis by Tax Foundation economists shows that such revenues jumped nearly 10 percent from fiscal 1982 to fiscal 1983, an increase of \$15.9 billion, and a total income of \$179.1 billion. Fiscal 1983 also marked the fourth consecutive year that localities increased the share of total general revenues raised from their own sources, according to analysts at the Washington-based tax watchdog organization.

The rise in local own-source revenues far outpaced increases in similar categories of revenue at both the Federal and state levels. Fiscal 1983 own-source general revenues of the states rose by about 6 percent (\$11.8 billion), while Federal general revenue collections actually dropped by \$14.1 billion (about 3 percent).

Of total local general revenue from all sources totaling \$298.5 billion in 1983, 60 percent came from local sources. This share was up from 58.5 percent in 1982 and was higher than in any year since 1973, when Federal general revenue sharing became effective.

As a share of local general revenue, Federal and state financial aid peaked at 44.7 percent in 1979. At that time, this aid totaled \$94.8 billion. Although intergovernmental grants grew by \$24.6 billion (26 percent) between 1979 and 1983, to a total of \$119.4 billion, locally raised revenue jumped by \$61.9 billion (53 percent) at the same time.

The Federal contribution to local government rose sharply during the 1970s, reaching a high of 10 percent of local general revenue in 1978. This share has fallen in each year since, to a level of 7.0 percent in 1983. Although the dollar amount of Federal aid to localities rose slightly in 1983 from the previous year, it was still \$1.4 billion below its high of \$22.4 billion in fiscal 1981.

State aid to local units since 1970 has ranged between 33.0 and 35.0 percent of local general revenues. Fiscal 1983 state aid of \$98.4 billion represented 33.0 percent of local revenue, down from 35.0 percent in 1979 and 1980, and the lowest percentage since 1968.

On balance, despite fluctuations during the decade, local governments in fiscal 1983 were raising about the same share of their budgets as they had in 1973, according to Tax Foundation analysts. But a major shift occurred in the tax versus nontax mix of the funds. The share of local revenue coming from local taxes dropped from 44.8 percent in 1973 to 37.9 percent in 1983. Nontaxes—charges and miscellaneous general revenues—moved up from 14.7 percent to 22.1 percent of the total.

In dollar amounts, local taxes rose from \$53.0 billion in 1973 to \$113.1 billion in 1983, a 113 percent rise. At the same time, nontax revenues grew from \$17.5 billion to \$66.0 billion, or 278 percent.

In fiscal year 1983, for every dollar raised by local units in taxes, 58 cents was raised in nontax general revenues; this share was up from 33 cents ten years earlier.

The major elements of the nontax revenues that have led to these effects are current charges for goods

and services provided to users and interest earnings on financial assets held by local governments.

Current charges rose from \$12.3 billion in 1973 to \$39.4 billion in 1983, more than tripling. For every tax dollar raised in 1973, current charges produced 23 cents; by 1983 it was 35 cents. (For local governments, current charges come from a variety of fees and charges such as school lunch sales, college tuition, hospital charges, sewerage and sanitation fees, parks and recreation, air transportation, housing and urban renewal receipts, and others.)

Other nontax general revenue, labeled "miscellaneous general revenue," totaled \$26.6 billion in 1983, over five times the \$5.2 billion coming from such sources in 1973. These include receipts from special assessments, sales of property, interest earnings and other sources. A significant factor in the decade's rise was interest earnings on cash and security holdings of local governments. These earnings came to \$13.9 billion in fiscal 1983, more than seven times the \$1.9 billion earned ten years earlier. The rise is due both to general increases in interest rates over the decade, as well as to larger financial holdings of local jurisdictions, according to Tax Foundation analysts. Yields on top grade corporate bonds, for example, rose from an average of 7.44 percent in 1973 to 12.04 percent in 1983 (more than 60 percent). At the same time, cash and security holdings of states and localities (excluding the substantial amounts held for insurance trust programs such as employee retirement and unemployment compensation) rose from \$47.9 billion to \$134.9 billion at the end of fiscal 1983. (Separate figures on asset holdings are not available for local governments alone.)

In every year since 1972 local units as a whole have experienced surpluses on their general accounts, as

(Continued on page 6)

"Fiscal 1983 marked the fourth consecutive year that localities increased the share of total general revenues raised from their own sources."

Currently Available

"Flatter Taxes and Fatter Bases: An Evaluation of Current Proposals," Special Report, 28 pp., \$10.00 (\$7.50 members).

"State Income Taxation of Multinational Corporations," Proceedings of a Tax Foundation Seminar, May 1984, 35 pp., \$15.00 (\$12.00 members).

"State Taxation and Business Climate," Research Bibliography No. 71, February 1985, 10 pp., \$4.00.

"At Issue: Is Corporate Investment Income Taxed Too Lightly?" by Jack F. Bennett, Fiscal Policy Forum, Winter 1985, 4 pp., \$1.00.

"At Issue: Taxpayers vs. Tax Spenders—Who's Less Honest?" by Leif H. Olsen, Fiscal Policy Forum, Fall 1984, 6 pp., \$1.00.

"At Issue: Tax Compliance," by Duane R. Kullberg and Roscoe L. Egger, Jr., Fiscal Policy Forum, Spring 1984, 8 pp., \$1.00.

"Expenditure Control: The True Road to Tax Reform," Murray L. Weidenbaum, January 1985, 4 pp., \$1.00.

(Plus \$1.00 postage and handling on all orders.)

Percentage Distribution of Local General Revenue by Source
Selected Fiscal Years 1902-1983

Year	Amount* (millions)	Percent of Total						
		Total	From own sources				Intergovernmental	
			Total	Taxes Property	Other	Charges and miscellaneous	From state	From Federal government
1902	\$ 854	93.4	82.4	73.1	9.3	11.0	6.1	.5
1913	1,637	94.1	79.9	72.8	7.1	14.2	5.6	.4
1922	3,866	91.7	79.4	76.9	2.5	12.3	8.1	.2
1932	5,690	85.7	75.1	73.1	2.0	10.6	14.1	.2
1940	6,939	72.2	64.8	60.1	4.7	7.3	23.8	4.0
1950	14,014	68.4	57.0	50.2	6.8	11.4	30.1	1.5
1960	33,026	69.4	54.7	47.8	6.9	14.6	28.8	1.8
1965	47,527	68.1	52.8	45.9	6.9	15.2	29.5	2.4
1969	71,943	63.7	48.3	41.3	7.0	15.4	33.1	3.1
1970	80,917	63.5	48.0	40.7	7.3	15.5	33.3	3.2
1971	91,963	62.5	47.2	39.9	7.3	15.3	33.8	3.7
1972	105,243	62.3	47.3	39.5	7.8	15.0	33.4	4.3
1973	118,392	59.6	44.8	37.1	7.7	14.8	33.8	6.7
1974	131,434	58.4	43.0	35.3	7.7	15.4	33.9	7.8
1975	146,307	57.7	41.9	34.2	7.7	15.7	34.9	7.4
1976	162,931	57.2	41.5	33.7	7.8	15.7	34.5	8.3
1977	179,045	57.1	41.8	33.7	8.1	15.3	33.7	9.2
1978	194,784	56.8	41.3	32.9	8.4	15.6	33.2	10.0
1979	211,987	55.3	38.0	29.5	8.5	17.3	35.0	9.7
1980	232,452	55.9	37.2	28.2	9.0	18.8	35.0	9.1
1981	257,180	56.7	36.9	28.0	8.9	19.8	34.6	8.7
1982	279,203	58.5	37.1	28.2	8.9	21.3	34.0	7.5
1983	278,542	60.0	37.9	28.8	9.1	22.1	33.0	7.0

*General revenue represents total revenue less utility, liquor store, and insurance trust revenue.

Source: Department of Commerce, Bureau of the Census; percentage computations by Tax Foundation.

(LOCAL REVENUES, from page 5)

measured by the Bureau of the Census. In 1983, general revenues of all local jurisdictions totaled \$298.5 billion, or \$14.6 billion more than general spending of \$283.9 billion. While local units generally have requirements that operating budgets be in balance, capital projects are typically financed separately, by long-term bond issues, and there is no requirement for the matching of annual revenue and outlay of capital budgets. In fact, throughout the 1950s and 1960s, and until 1973—when Federal general revenue sharing began—local government general spending exceeded general revenues in each year.

These observations are based on totals for some 82,000 local jurisdictions, nearly 66,000 of which have property-taxing powers. General financial surpluses shown as totals may obscure varying conditions among individual jurisdictions, say Tax Foundation economists. However, 1983 general revenues exceeded general spending in each category of jurisdictions—counties, municipalities, townships, special districts, and school districts—and in all but eight states.

The table above provides further details.

New Publication

"State Taxation and Business Climate," Research Bibliography No. 71, has just been issued by the Tax Foundation. A selective bibliography of resources available, it is divided into four sections: Business Climate Ranking Studies, Business Location Decisions, Taxation and Business Climate, and Interjurisdictional Tax Comparisons. 10 pp. \$4.00, plus \$1.00 postage and handling.

(ERTA TAX CUTS, from page 1)

taxes, and \$3.5 billion to social insurance contributions (largely employer payroll taxes).

The Highway Revenue Act of 1982 added \$4.4 billion to 1985 receipts by raising the tax on gasoline and motor fuels by 5 cents a gallon, and hiking some highway user fees.

In 1983, the Social Security Amendments and the Railroad Retirement Revenue Act boosted 1985 social insurance taxes by a total of \$10.3 billion (with some offsets in individual income taxes). Other 1983 legislation operated in reverse, reducing taxes by about \$2.4 billion by repealing the withholding of interest and dividends that had been scheduled under TEFRA.

The tax-increasing mood again prevailed in Congress last year, when it approved the Deficit Reduction Act of 1984, raising 1985 taxes by \$9.3 billion, primarily by boosting individual income taxes by \$5.6 billion and

(Continued on page 7)

Conferences Planned

Tax policy conferences under Tax Foundation sponsorship are being planned for the following dates:

Tuesday, June 4, 1985
 Washington D.C.

Tuesday, September 10, 1985
 Atlanta, GA

Details of the program and speakers will be announced in future issues of *Tax Features*, or contact:
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 Washington, DC 20005
 202/822-9050

(ERTA TAX CUTS, from page 6)

corporate profits taxes by \$3.3 billion.

Additionally, there were social security tax increases totaling \$22.0 billion as a result of four automatic annual increases in the indexed maximum social security base and pre-1981 legislation that had scheduled future social security tax rate hikes.

On balance, individual income taxpayers fared better than corporate payers in the 1982-84 changes. Individual payers in 1985 are getting a cut from pre-ERTA levels of \$117.0 billion—only 12 percent less than the amount provided by ERTA. For corporate payers, the actual reduction from pre-1981 amounts will be only \$10.5 billion—66 percent less than originally offered by ERTA. Both individuals and corporations will share

the added \$31.9 billion in social insurance contributions resulting from changes in tax rates and structure during the 1981-1985 period.

Despite the reductions resulting from tax legislation, expansion of the economic base will raise actual Federal receipts in fiscal 1985 about \$220 billion or 42 percent above 1980 collections. Social insurance contributions, which rose 70 percent in the five-year period, account for 50 percent of the 1980-1985 total dollar increase. Individual income taxes, rising 35 percent, made up 39 percent of the aggregate dollar rise in Federal receipts. All other categories of receipts showed smaller gains, with the exception of estate and gift taxes, which are estimated to be about 12 percent less in 1985 than in 1980.

THE FRONT BURNER

By Robert C. Brown
President
Tax Foundation, Incorporated

"Gimme Shelter"

The numbers vary, depending on the source of the data, the mechanism of tax avoidance, the methods used to calculate tax payments, and other variables. But one thing is clear. Tax shelters are big business.

A tax shelter usually has these components: large deductions now for depreciation and interest, and deferred taxes on earnings, with possible capital gains treatment for those receipts at the end of the investment. What's so terrible about that? Why such bad press for a device that simply allows Americans to keep more of what they earn?

Within certain limits, we're all for tax shelters. While everyone accepts the need to shoulder our share of public costs, no one wants to pay more than the law absolutely requires. Having said that, there are a number of worrisome aspects to the tax shelter bonanza that has turned this field into a growth industry in recent years. They deserve at least a passing glance from every thoughtful American.

- The spread of tax shelters has led to investment decisions driven by tax considerations, rather than by economic or business goals. This does not help American productivity or competitiveness in world markets.

- Marginally productive—or nonproductive—tax shelters like jojoba bean farms or commodity tax straddles divert needed capital resources into inefficient channels, distorting the true interplay of market forces in the economy. One result is the present nationwide glut of commercial office space.

- Sheltering billions of dollars of potentially taxable income—\$35 billion in partnership "losses" alone in 1983—seriously reduces the revenue pool available to Uncle Sam.

- This narrowing of the tax base raises taxes for those without sheltered income.

- A great deal of legal, accounting and marketing talent diverts from productive involvement into the highly lucrative areas of devising and running tax shelters.

- The unsophisticated are lured into tax-avoidance

schemes of questionable legality and wind up not only losing the shelter but paying penalties for trying to beat the tax collector. Of the 1.2 million returns audited in fiscal 1984, the IRS reports that 100,000 involved abusive tax shelter investments, with an average assessment for back taxes and penalties totaling \$19,000.

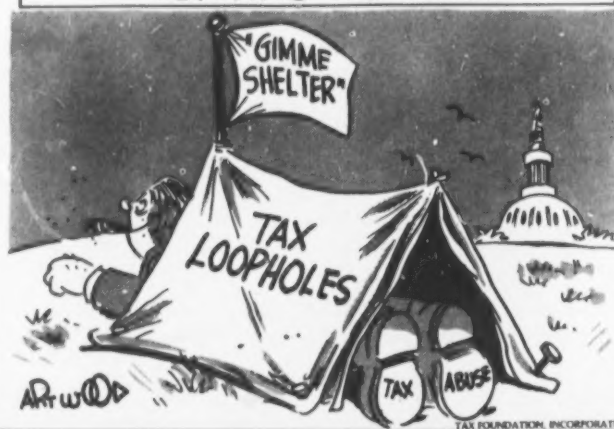
The Administration and Congress are now seeking ways to close the gap between Federal revenues and outlays. They should take a good look at tax shelters. Loophole closing and stiffer enforcement in this area would bolster revenues significantly.

Even more important than the dollars and cents involved, however, is a consideration touched on recently by IRS Commissioner Roscoe L. Egger. "People resent a system which gives special privileges to a few," he cautioned, "making it more costly and tougher on everybody else." If our system of public finance is not to collapse under the combined weight of distrust, disrespect and disparity, we had better heed the Commissioner's warning.

In one area that will both broaden the base and increase fairness—doing away with overuse and abuse of tax shelters—it is time for the train to leave the station.

"The spread of tax shelters has led to investment decisions driven by tax considerations, rather than by economic or business goals. This does not help American productivity or competitiveness in world markets."

TENTING TONIGHT



TAX FOUNDATION, INCORPORATED

"The real bite in the 1984 law will come when the IRS regulations are written and enforced."

(FRINGE BENEFITS, from page 4)

has interpreted this Section to mean that "all accessions to wealth" are subject to tax unless specifically exempted. This decision, in 1961, laid the legal base for the present drive to tighten the tax net on fringes, because Congress so far has given statutory exemption to a fairly short list of benefits. The most important are employer contributions to pension, health and disability plans; group life insurance up to \$50,000; group legal services; meals, lodging and transportation furnished for the employer's convenience; employer's van-pool commuting; parsonage allowance, scholarships and housing aid for employees of educational institutions and their dependents; employer-provided child and other dependent care aid.

A Drive Begins . . .

In the mid-1970s, the U.S. Treasury and IRS began a joint campaign to impose taxes on the growing array of benefits, which had become a key element in wage agreements and executive compensation. A quirk of history actually touched off the action, when Congress' Joint Committee on Taxation issued a report in 1974 demanding taxation on the value of improvements made to President Richard Nixon's personal residences, and personal use of the presidential airplane (Air Force One). The Treasury under President Ford followed up with a draft of proposed regulations in 1975 taxing fringe benefits unless they were job-related and available to substantially all employees. This "First Draft" was withdrawn in the face of widespread criticism. In fact, in 1978 Congress showed its favorable attitude toward untaxed fringes by authorizing "cafeteria" plans—flexible benefits permitting individuals to select the type and level of benefits best suited to their age and family needs, to the extent provided by an approved company plan—and by specifically barring the IRS from issuing new income tax regulations on fringes until 1980. That moratorium was extended to December 31, 1983 in subsequent legislation. But court decisions and IRS rulings kept the fringes issue boiling. And Treasury staff tax experts continued to press for tighter tax rules on benefits.

The Net Tightens . . .

In the Tax Reform Act of 1984, part of the Deficit Reduction Act, Congress wrote into law "safe harbor" rules protecting some fringes from income and payroll taxes while tightening rules on others. Most importantly, Congress reaffirmed by this statute the principle that fringe benefits are to be treated as income subject to both income and employment (social security) taxes under regulations issued by the IRS, except where exempted by statute. This is intended to bar the door against new untaxed fringes including innovations in executive compensation packages.

What the Future Holds

The fringes "safe harbored" by the '84 law: Qualified employee discounts on plane/train tickets, clothing, etc. (generally not more than 20 percent below market prices); subsidized eating facilities; employer-provided services where the employer's cost is not substantial; working-conditions fringes such as free parking and special clothing items; qualified athletic facilities; subsidized tuition for employees of educational institutions; other benefits too inexpensive or difficult to track (a secretary's typing of a personal letter, for example).

Benefits brought under tighter rules and limits, generally starting January 1, 1986, affect mainly higher-income employees and include Employee Stock Ownership Plans (ESOPs); luxury cars; life insurance above \$50,000 in cafeteria plans; "golden parachutes" for top executives caught up in mergers; Voluntary Employees Beneficiary Associations (VEBAS) providing upper-range insurance and pension benefits.

The real bite in the 1984 law will come when the IRS regulations are written and enforced. A hint of the complexities these rules will spawn is found in the January 3, 1985 IRS release of a 72-page booklet of questions and answers about proposed regulations for computing the taxable value of company cars, free airline tickets, child-care aid, etc. In everyday real life, your local IRS agent will decide how to apply these rules—that is, how much tax you and your employer will pay on a given benefit.



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TAX·FEATURES

April 30 is Tax Freedom Day!

U.S. Workers Are on the Job 120 Days Just to Pay Taxes

April may be "the cruelest month," as the poet said. But it will not be quite so cruel to U.S. taxpayers this year, say Tax Foundation economists.

Tax Freedom Day 1985 falls in April—on the 30th, and this is only the second year since 1975 that this occasion has occurred by the end of April. (Revised data for 1984 now indicate that Tax Freedom Day fell on April 29 last year.)

Tax Freedom Day is a benchmark calculated by economists at the Washington-based tax watchdog organization to indicate when the average taxpayer would finish fulfilling his responsibilities to Federal, state, and local governments if every dollar earned from January 1 went to the tax man. The trend for this date to move earlier in the calendar has been apparent since 1982, the first year the Reagan tax cuts began to take hold.

The continued phase-in of those tax cuts, coupled with improved economic performance, has continued this tendency, despite several new Federal laws since 1981 that have hiked income and social insurance taxes, and some statutory increases in state-local levies.

The average U.S. taxpayer now works 120 days to get the tax collector off his back. Unpleasant as this situation may seem, for nine of the past ten years the average taxpayer finished the job even later in the year. As recently as 1981, the U.S. taxpayer worked 126 days—until May 6—just to pay his tax bills.

The table below provides further details.

**Tax Freedom Day
Selected Years, 1930-1985**

Year	Tax Freedom Day
1930	February 13
1940	March 8
1950	April 3
1960	April 17
1970	April 28
1975	April 28
1980	May 4
1981	May 6
1982 ^a	May 4
1983	May 1
1984 ^a	April 29
1985 ^b	April 30

^a Revised. ^b Forecast.

Uncle Sam Gets 1 Hr. 43 Mins. States-Locals Take 55 Mins.

Federal, state, and local taxes will take a 2-hour 38-minute bite from the average U.S. worker's 8-hour earnings, according to calculations by economists at the Tax Foundation. This is a minute longer than last year, but 5 minutes less than the bite taken by the tax man in 1980, say researchers at the Washington-based tax watchdog organization.

Uncle Sam, as always, takes the lion's share. The American worker must put in 1 hour and 43 minutes to satisfy his obligations to the IRS. State and local governments combined take about half that much time: 55 minutes, to be precise.

Taxes claim more than any other item of expenditure from that 8-hours' worth of work. Housing and household operations are second, requiring 1 hour and 34 minutes. Other major costs are food and tobacco (59 minutes), transportation (42 minutes), and medical care (35 minutes).

Tax Foundation economists note that the 5-minute drop in the tax bite since 1980 has been exactly offset by an equivalent increase in housing costs. Medical care also claims 5 additional minutes of the workday's earnings, while food (including tobacco) and clothing have dropped 6 minutes and 1 minute, respectively.

The table below supplies details.

**Tax Bite in the Eight-Hour Day and Tax Freedom Day
1980-1985**

Item	1980	1981	1982 ^b	1983	1984 ^b	1985 ^c
Taxes	2:43	2:45	2:42	2:39	2:37	2:38
Federal	1:49	1:52	1:47	1:43	1:42	1:43
State and local	:54	:53	:55	:56	:55	:55
Food and tobacco	1:05	1:03	1:05	1:04	:58	:59
Housing and household operation	1:29	1:28	1:35	1:36	1:33	1:34
Clothing	:22	:21	:22	:22	:22	:21
Transportation	:42	:41	:42	:42	:42	:42
Medical care	:30	:30	:34	:34	:35	:35
Recreation	:19	:19	:20	:20	:20	:20
All other ^a	:50	:54	:40	:43	:53	:51

Tax Freedom Day: May 4 May 6 May 4 May 1 April 29 April 30

^aIncludes personal care, personal business, private education and research, religious and welfare activities, net foreign travel, and net savings.

^bRevised.

^cForecast.

Source: Tax Foundation, derived from data supplied by U.S. Department of Commerce, Bureau of Economic Analysis.

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Tax Uncertainty**

Estimated Total and Per Capita Federal Tax Burdens, by State
Fiscal Years 1984-1986

State	Total burden (millions)			Per capita burden			State rank 1985	
	1984	1985	1986	1984	1985	1986	Total	Per capita
TOTAL	\$645,043	\$714,248	\$770,423	\$2,738	\$3,010	\$3,216	—	—
Alabama	8,276	9,158	9,852	2,094	2,312	2,477	25	46
Alaska	2,266	2,506	2,700	4,340	4,556	4,647	44	1
Arizona	7,257	8,050	8,699	2,365	2,562	2,699	27	36
Arkansas	4,557	5,044	5,426	1,960	2,165	2,318	33	49
California	77,503	85,800	92,607	3,012	3,282	3,480	1	10
Colorado	9,450	10,481	11,330	2,911	3,158	3,331	23	12
Connecticut	11,873	13,156	14,222	3,807	4,218	4,552	19	3
Delaware	1,845	2,042	2,201	3,050	3,364	3,614	48	9
Florida	29,189	32,366	34,978	2,630	2,844	2,991	6	27
Georgia	13,523	14,993	16,184	2,325	2,548	2,714	13	37
Hawaii	2,813	3,114	3,360	2,694	2,941	3,119	38	25
Idaho	2,062	2,281	2,454	2,056	2,250	2,390	45	47
Illinois	34,703	38,386	41,365	3,045	3,373	3,633	4	8
Indiana	13,620	15,080	16,250	2,517	2,797	3,019	12	29
Iowa	7,164	7,929	8,544	2,498	2,775	2,997	28	31
Kansas	6,954	7,700	8,305	2,859	3,152	3,376	29	13
Kentucky	7,770	8,596	9,248	2,100	2,320	2,487	26	44
Louisiana	11,023	12,207	13,163	2,439	2,665	2,830	21	34
Maine	2,489	2,753	2,961	2,174	2,401	2,568	42	41
Maryland	13,477	14,946	16,162	3,131	3,461	3,724	14	6
Massachusetts	18,155	20,094	21,669	3,175	3,519	3,794	10	5
Michigan	24,014	26,562	28,600	2,708	3,024	3,280	9	21
Minnesota	11,307	12,527	13,515	2,735	3,024	3,251	20	20
Mississippi	4,610	5,106	5,499	1,777	1,959	2,096	32	51
Missouri	12,820	14,200	15,313	2,594	2,872	3,091	16	26
Montana	1,948	2,158	2,324	2,364	2,597	2,767	46	35
Nebraska	4,009	4,443	4,798	2,515	2,782	2,991	35	30
Nevada	2,677	2,960	3,187	2,866	3,073	3,203	40	17
New Hampshire	2,767	3,068	3,316	2,855	3,137	3,351	39	14
New Jersey	26,956	29,848	32,206	3,624	4,008	4,312	8	4
New Mexico	3,137	3,478	3,752	2,180	2,371	2,503	37	42
New York	53,579	59,306	64,001	3,056	3,387	3,653	2	7
North Carolina	13,478	14,934	16,106	2,199	2,418	2,584	15	40
North Dakota	1,859	2,053	2,208	2,706	2,958	3,145	47	23
Ohio	28,197	31,204	33,631	2,660	2,957	3,196	7	24
Oklahoma	8,692	9,634	10,401	2,544	2,754	2,900	24	32
Oregon	6,546	7,242	7,792	2,472	2,734	2,936	31	33
Pennsylvania	31,941	35,322	38,024	2,712	3,006	3,238	5	22
Rhode Island	2,635	2,912	3,132	2,777	3,072	3,300	41	18
South Carolina	6,662	7,380	7,953	2,014	2,207	2,349	30	48
South Dakota	1,478	1,638	1,767	2,117	2,347	2,521	50	43
Tennessee	10,670	11,806	12,706	2,278	2,513	2,691	22	38
Texas	46,162	51,193	55,355	2,813	3,035	3,186	3	19
Utah	3,384	3,745	4,031	2,000	2,151	2,247	36	50
Vermont	1,184	1,310	1,410	2,246	2,476	2,645	51	39
Virginia	15,802	17,499	18,879	2,822	3,099	3,309	11	16
Washington	12,607	13,955	15,045	2,901	3,182	3,392	17	11
West Virginia	4,088	4,519	4,858	2,095	2,317	2,489	34	45
Wisconsin	12,019	13,303	14,335	2,545	2,817	3,031	18	28
Wyoming	1,540	1,706	1,839	2,889	3,125	3,283	49	15
District of Columbia	2,310	2,557	2,759	3,799	4,247	4,621	43	2

Source: U.S. total taxes as shown in the federal budget submitted February 1985; computations of total and per capita tax burdens by state were made by Tax Foundation.

Tax Features

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CA, NY, TX Top Payers Of Federal Tax Bill

Federal taxes will hit \$714,248 billion in the current fiscal year (1985), according to Tax Foundation economists. The Administration's 1986 Budget as presented to Congress on February 4 projects an increase of \$69.2 billion (10.7 percent) over the \$645,043 billion collected in 1984. Federal tax revenues for fiscal 1986 are projected to climb by \$56.2 billion (7.9 percent) over 1985 levels. The burden falls unevenly upon the states.

California, New York, and Texas lead the pack again in the current fiscal year for the questionable distinction of having the largest Federal tax burdens in the nation. Predictably, the total dollar amounts taken in by Uncle Sam tend to be highest in states with the largest populations, explain Tax Foundation analysts.

Citizens in the ten states with the heaviest total tax burdens will pay over 57 percent of all Federal taxes, even though they have less than 54 percent of the population. These "top ten" pay about \$410.1 billion of all Federal taxes collected. Ranked in descending order of total Federal tax burden, they are:

CA	\$85.8 billion
NY	\$59.3 billion
TX	\$51.2 billion
IL	\$38.4 billion
PA	\$35.3 billion
FL	\$32.4 billion
OH	\$31.2 billion
NJ	\$29.8 billion
MI	\$26.6 billion
MA	\$20.1 billion

Except for Massachusetts, the ten states with heaviest burdens are also among the top ten in population.

Sharply contrasting with the huge tax load of the "top ten" states is the tax burden borne by the lowest ten. The following contain about 3 percent of the population and will bear 3 percent of the Federal tax burden (\$21.1 billion) in fiscal year 1985:

ME	\$2.8 billion
DC	\$2.6 billion
AK	\$2.5 billion
ID	\$2.3 billion
MT	\$2.2 billion
ND	\$2.1 billion
DE	\$2.0 billion
WY	\$1.7 billion
SD	\$1.6 billion
VT	\$1.3 billion

Except for Idaho and Maine, the ten states with lowest total tax burdens rank in the ten states with the fewest residents.

On the other hand, per capita tax burdens tend to hit hardest in states with relatively high average income levels. In fiscal year 1985, residents in the ten states with the highest per capita tax burdens will pay approximately 37.6 percent of the tax bill, about \$268.6 billion. Their average Federal tax burden will be \$3,471, about 15 percent higher than the national average of \$3,010. Those residing in the ten states with the lowest

(Continued on page 4)

\$6,346 Federal Tax Bill for \$26K Earner

The Federal government is spending an estimated \$959.1 billion in fiscal year 1985. For a moderate-income family—one worker earning \$26,000 solely from wages with a spouse and two dependent children—this will mean a tax bill of \$6,346, according to Tax Foundation economists.

As spending approaches the trillion-dollar range, the place of the ordinary taxpayer in the system may be hard to visualize. To provide some perspective, analysts at the Foundation break down the Federal spending in terms relating to the tax bill of this \$26,000-a-year

family.

"Income security" is the most costly item among all functions. This includes social security and Federal employee retirement and disability, unemployment insurance, housing assistance, food and nutrition assistance, and other programs. Uncle Sam will lay out a total of \$318.3 billion for these items. For the \$26,000 earner, the cost is \$2,038. In other words, for each \$1 this taxpayer sends to Washington, the Federal government will pay out .2 cents for "income security" programs.

(Continued on page 4)

THE FRONT BURNER

By Robert C. Brown
President
Tax Foundation, Incorporated

"Hacking Through the Tax Law Jungle"

Would you tell me, please, which way I ought to go from here?" asked Alice. "That depends a good deal on where you want to get to," said the Cat. "I don't much care where—" said Alice. "Then it doesn't matter which way you go," said the Cat.

That, in a nutshell, characterizes U.S. tax policy in the last five years: an elected leadership with no clearly defined policy goals stages random revenue forays into whatever sector of the taxpaying community seems most vulnerable and least likely to mount an effective counter-offensive. Not knowing where it wants to go, the national government has gone for the gold—seeking short-term revenue gains to keep deficits from becoming even larger. The result—in terms of efficiency, consistency, and simplicity in the tax system of the nation—has been a disaster.

Not that the current generation of legislators is unique. Certainty has been hard to come by since the beginning. The first income tax law, Section 11 of the Simmons Tariff Act (HR 3321) in 1913, took 16 pages and 8,000 words to nail down what was essentially a 1 percent base tax on taxable income above \$4,000 a year, plus an additional tax starting at 1 percent at \$20,000 and progressing up to 6 percent on income over \$500,000 a year, for a maximum rate of 7 percent.

The quest for certainty has been sharply downhill ever since, and uncertainty now rules the land. Today's Internal Revenue Code is a legislative jungle of 3,000 pages and an estimated 1.5 million words.

To make the system fairer, to raise more revenue, and to further "desirable" social goals, lawmakers have enacted a raft of tax laws in the last 72 years. The early pace—one major tax law every four years or so—created complexity but at least allowed some degree of certainty during the first 25 years under the Code.

The Sixties and Seventies saw 11 major laws in 16 years, raising uncertainty to a kind of art. Then came the Eighties—major tax action every year with each law more complex than its predecessor.

This would be merely ludicrous if the nation's eco-

nomic life were not disrupted. But consider this:

- Whether through fear of making a mistake for which they will be penalized or of paying tax that some change has made unnecessary, an increasing number of Americans are turning to tax preparers.
- For their part, preparers can no longer be certain that their interpretations of the tax maze are correct.
- The Internal Revenue Service is in a state of gridlock, as more than 450 rules, some dating back to 1978, await decisions.
- State legislatures find their constitutional power to raise revenues impeded, as the impact of Federal laws on their rule-making grows cloudier by the year.
- Corporate America reels from the need to adjust and readjust as revenue and social policy driven alterations turn the Code into an indecipherable crazy-quilt.

These are just some of the conclusions in a recent Tax Foundation thought-starter entitled "Tax Uncertainty: As American as Apple Pie." I recommend it for your reading. Maybe it will upset you enough that you will add your voice to the chorus calling for Washington to straighten out the mess that the Tax Code has become—and then leave it alone for a good long time.

Editor's note: Copies of "Tax Uncertainty: As American as Apple Pie" are available for \$2.50 from the Tax Foundation. Please add \$1 for postage and handling per order.

"Corporate America reels from the need to adjust and readjust as revenue and social policy driven alterations turn the Code into an indecipherable crazy-quilt."

INDIANA JONES



TAX FOUNDATION, INCORPORATED

(FEDERAL TAX BURDEN, from page 2)

per capita tax burdens will pay \$50.9 billion, or 7.1 percent of the total. Their average tax burden works out to \$2,233 per person, about 25 percent below the national average.

"Top Per Capita"		"Bottom Per Capita"	
AK	\$4,556	NM	\$2,371
DC	\$4,247	SD	\$2,347
CT	\$4,218	KY	\$2,320
NJ	\$4,008	WV	\$2,317
MA	\$3,519	AL	\$2,312
MD	\$3,461	ID	\$2,250
NY	\$3,387	SC	\$2,207
IL	\$3,373	AR	\$2,165
DE	\$3,364	UT	\$2,151
CA	\$3,282	MS	\$1,959

Tax Foundation procedures for deriving these state estimates have been in use for more than 25 years and state tax burdens are updated annually. The listing is designed to show where Federal tax dollars actually originate, rather than where they are collected. By contrast, U.S. Treasury figures, which show where taxes are collected, do not purport to provide a picture of the state-by-state impact of Federal taxation, according to Tax Foundation economists.

An example of how the two methodologies differ appears in comparison of data related to the collection of Federal excise taxes on tobacco products. Treasury data show these taxes as collected mainly in a few southern states. However, Tax Foundation economists point out that the burden of these taxes may be assumed to fall on consumers of these products in all states, so that collections data published by Treasury do not show who is actually bearing the burden of these taxes.

The table on page 2 provides further details.

"Altogether, direct and indirect Federal taxes claim over 24 percent of this family's annual income."

How the Federal Government Will Spend A Worker's Tax Dollars in Fiscal 1985^a

Function	Worker's share		Total spending (millions)
	Amount	Percent of total	
Income security ^b	\$2,038	32.11	\$318,347
National defense	1,624	25.60	253,830
Net interest	835	13.16	130,426
Health ^c	641	10.10	100,135
Education, training, employment, and social services	195	3.07	30,434
Transportation	173	2.72	26,994
Veterans' benefits and services	172	2.71	26,850
Agriculture	129	2.03	20,165
International affairs	126	1.98	19,583
Natural resources and environment	83	1.31	13,024
General science, space, and technology	56	.88	8,740
Community and regional development	55	.86	8,553
Energy	52	.82	8,164
Administration of justice	43	.67	6,686
General purpose fiscal assistance	42	.66	6,552
Commerce and housing credit	38	.60	5,987
General government	37	.58	5,782
Allowances and contingencies	7	.11	1,131
Total	\$6,346	100.00	\$959,085 ^d
Exhibit:			
Payments for individuals	\$2,735	43.10	\$427,332

^aIn this example, the worker is the sole source of support for a spouse and two dependent children, and earns \$26,000 per year. Government spending includes budget and off-budget items.

^bIncludes social security, Federal employee retirement, unemployment compensation, housing assistance, food and nutrition assistance; excludes veterans' income security.

^cIncludes medicare, medicaid, and others; excludes veterans' hospital and medical care.

^dAfter deducting \$32,296 million in undistributed offsetting receipts not classified by function.

Source: Tax Foundation computations, based on Federal Budget presented February 4, 1985 (Office of Management and Budget) and tax laws from Treasury Department.

June Conference Planned

A tax policy conference on "Tax Reform Implications for International Business" will be sponsored by the Tax Foundation on Tuesday, June 4, 1985, in Washington, D.C. at the Washington Plaza Hotel.

Topics to be discussed at the conference will include proposed changes in the foreign tax credit and Section 936 applying to Puerto Rico.

Details on speakers and registration will appear in the May issue of *Tax Features*, or please call the Tax Foundation.

(WORKER'S TAX DOLLARS, from page 3)

National defense will claim \$253.8 billion in Federal outlays this year, or 26 cents out of each tax dollar. For the moderate-income taxpayer described here, this amounts to \$1,624. The third most expensive item is interest on the public debt. Net interest in 1985 will cost \$130.4 billion; for this worker, the tab will be \$835, over 13 cents per dollar of taxes. Health outlays, totaling more than \$100.1 billion, will cost the moderate-income family \$641, or 10 cents for each tax dollar paid.

These four big programs account for more than 80 percent of all Federal spending. Other functional programs that will cost the moderate-income taxpayer over \$100 in 1985 are: education, training, employment, and social services (\$195); transportation (\$173); veterans' benefits and services (\$172); agriculture (\$129); and international affairs (\$126). The costs of the remaining functional programs are shown in the accompanying table.

Foundation analysts call attention to another category of major Federal spending that cuts across functional lines as classified in the budget. This is "payments for individuals." In 1985 these payments will add up to \$427.3 billion. For this moderate-income family, the cost is \$2,735, or 43 cents of every tax dollar. Included in this classification are the income security items shown above; payments for veterans; assistance to students; health and medical care under medicare and medicaid and other programs; and other payments to individuals under special programs.

The money to support government programs comes from taxes, nontaxes, and borrowing. The individual income tax provides the biggest share of the tax money. For this \$26,000-a-year family, the income tax will take \$2,137 from annual earnings. Social security taxes divert another \$1,833 to Uncle Sam. Direct levies account for only about three-fifths of the Federal tax take, according to Tax Foundation analysts. To these must be added a number of indirect taxes—employer's share of social security taxes; corporate income taxes; excise taxes on such items as gasoline, liquor and tobacco; and miscellaneous levies. These indirect taxes take another \$2,376 from the moderate earner's paycheck.

Altogether, direct and indirect Federal taxes claim over 24 percent of this family's annual income. But that's not the whole story.

In addition to paying a big slice of current earnings for taxes, the family must assume a share of the \$222.2 billion fiscal 1985 deficit. For the family described here, that burden is an additional \$1,974. All told, current Federal taxes and borrowing add up to \$8,320, or 32 percent of this moderate-income family's earnings.

TAX·FEATURES

Highest Earning Half of Population Pays 90% of All Federal Income Taxes

Nation's Tax Bill Now Measures Nearly Five Times '67 Level

The Tax Index climbed to a new high of 496.6 in the fourth quarter of 1984 (1967 = 100), as the nation's total tax bill came to nearly five times the levels recorded for the base year 1967, according to Tax Foundation economists.

Federal, state, and local taxes during the quarter, the latest for which data are available, were collected at a rate that would total \$1.090 trillion if continued for one year, reflecting a 9.6 percent annual rate of increase over the previous quarter.

The fourth quarter's rise was 2.5 percentage points (35 percent) higher than the concurrent 7.1 percent annual rate gain in the Gross National Product (GNP), the gross market value of the nation's output of goods and services. (Inflation-adjusted GNP rose 4.3 percent and general prices, 2.8 percent.)

The Tax Index is a fiscal yardstick designed by Tax Foundation economists to provide a continuing current measure of trends in taxes, on a basis comparable to official indexes for other segments of the economy.

Since the trough of the recession (fourth quarter 1982), the Tax Index has risen from 416.4 to 496.6 (1967 = 100), or 19.3 percent. Federal taxes have gone up just under 19 percent, and state-local taxes by over 20 percent. The rise in the Tax Index has been slightly less than the almost 21 percent gain in GNP over the same period.

(Continued on page 2)

Distribution of Federal income tax burdens among higher and lower income earners has been remarkably stable in recent years, despite major statutory changes affecting taxes at all income levels, according to Tax Foundation economists. Analysis of data for tax year 1983, recently released by the Treasury Department, reveals that the top-earning half of the population pays more than 90 percent of the Federal income tax bill. Earners in the top one-tenth pay over half of the bill.

These proportions were almost the same in 1983 as in 1978, Tax Foundation analysis reveals. There has been a tendency, however, for those at the upper end of the income scale to pay an increasing share of the individual income tax. The top 5 percent of income earners in 1983 shouldered 37.9 percent of the tax bill in 1983, up from 34.8 percent in 1978, according to Tax Foundation computations.

Federal individual income taxes totaled \$276.1 billion in 1983. Over \$257 billion—93.1 percent—was paid by the top 50 percent of earners—represented by the 48 million returns with incomes of \$14,888 or more. This group paid an average tax of \$5,339. Five years earlier, the upper half of taxpayers paid 93.5 percent of the taxes.

The 9.6 million taxpayers in the top ten percent grouping shouldered 50.3 percent of all U.S. personal income taxes in 1983—a shade more than their 49.6 percent share in 1978. In 1983, this group had adjusted gross incomes of \$41,501 or more, with an average tax burden of \$14,419.

The highest five percent of earners in 1983 had adjusted gross incomes averaging \$53,066 or more, and paid an average tax of \$21,704.

Taxpayers in the lower half of the earning scale—those making \$14,887 or less—paid only 6.9 percent of Federal income taxes in 1983, with an average tax of \$396. Their share of the tax bill was up slightly from 6.5 percent in 1978.

For all filers, the average tax per return in 1983 was \$2,867, an increase of 36.7 percent from 1978.

During the same five-year period there was a sharp increase in the

(Continued on page 2)

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"The 9.6 million taxpayers in the top ten percent grouping shouldered 50.3 percent of all U.S. personal income taxes in 1983."

**Federal Income Taxes Paid by High- and Low-Income Taxpayers
1978 and 1983**

Adjusted gross income class	Income level		Percent of tax paid		Average tax	
	1978	1983	1978	1983	1978	1983
Highest 5 percent	\$41,850 or more	\$53,066 or more	34.8	37.9	\$14,608	\$21,704
Highest 10 percent	29,428 or more	41,501 or more	49.6	50.3	10,405	14,419
Highest 25 percent	19,937 or more	27,806 or more	73.6	73.4	6,170	8,420
Highest 50 percent	10,972 or more	14,888 or more	93.5	93.1	3,921	5,339
Lowest 50 percent	10,971 or less	14,887 or less	6.5	6.9	273	396
Lowest 25 percent	5,047 or less	6,882 or less	.4	.6	33	72
Lowest 10 percent	1,933 or less	2,723 or less	(a)	(a)	9	12

(a) Less than .05 percent.

Source: Tax Foundation computations based on Treasury Department data.

Tax Index and Related Measures
Annually, and Quarterly at Seasonally Adjusted Annual Rates, 1967 = 100
Selected Periods, 1975-1984

Calendar year and quarter	Tax Index			Output Index ^a		
	Total	Federal	State and local	Current prices	Constant prices	Price Index ^b
Annually						
1975.....	204.3	191.0	232.1	193.8	122.0	158.8
1976.....	234.0	220.7	261.7	214.9	128.4	167.4
1977.....	263.1	249.7	291.1	239.9	135.4	177.1
1978.....	296.2	287.3	314.8	270.6	142.2	190.3
1979.....	331.5	328.4	338.0	302.4	146.3	206.7
1980.....	361.2	359.0	365.9	329.1	145.8	225.7
1981.....	411.9	414.6	406.2	369.9	149.5	247.4
1982.....	417.1	408.1	435.8	383.9	146.3	262.3
1983.....	441.3	424.2	476.9	413.3	151.7	272.4
1984.....	484.6	466.1	523.3	458.3	162.1	282.6
Quarterly						
1982 I.....	416.0	412.4	423.4	378.4	146.7	258.0
II.....	420.0	414.2	432.0	382.8	146.4	261.5
III.....	415.8	403.4	441.7	385.2	146.0	263.8
IV.....	416.4	402.3	445.9	388.9	146.2	266.0
1983 I.....	424.2	410.3	453.0	396.9	147.4	269.2
II.....	443.2	429.8	471.1	408.6	150.8	271.0
III.....	443.8	423.4	486.3	418.5	153.3	273.1
IV.....	453.8	433.1	496.8	429.2	155.5	276.0
1984 I.....	472.4	454.2	510.3	444.4	159.3	279.0
II.....	483.3	465.8	519.7	455.8	162.0	281.3
III.....	485.7	466.9	524.9	462.1	162.7	284.0
IV.....	496.6	477.1	537.2	470.8	164.6	286.0

^aGross national product.

^bImplicit price deflator for gross-national product.

Source: Tax Foundation computations and estimates based on data from U.S. Department of Commerce, Bureau of Economic Analysis.

Currently Available

Flatter Taxes and Fatter Bases: An Evaluation of Current Proposals, Special Report, February 1985, 28 p., \$10.00 (\$7.50, members).

Tax Uncertainty: As American As Apple Pie, Special Report, May 1985, \$2.50.

Federal Finances—A Two-Way Squeeze, *Proceedings of Tax Foundation's 36th National Conference*, December 1984, 38 p., \$8.00.

State Taxation and Business Climate, Research Bibliography No. 71, February 1985, 10 p., \$4.00.

At Issue: Is Corporate Investment Income Taxed Too Lightly?, by Jack F. Bennett, *Fiscal Policy Forum*, Winter 1985, 4 p., \$1.00.

State Income Taxation of Multinational Corporations, *Proceedings of a Tax Foundation Seminar*, May 1984, 35 p., \$15.00 (\$12.00, members).

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(TAX INDEX, from page 1)

Among the separate components of the Tax Index, the corporate profits index has scored the largest percentage gain since the 1981-1982 recession bottomed out in the fourth quarter of 1982. The corporate profits tax index has climbed by 61 percent. Its rate of growth was followed by an increase of 23 percent in the social insurance taxes index; 19 percent in indirect business taxes (property, sales, selective excises); 11 percent in the personal income tax index; and 6 percent in the index for all other taxes.

Measured against the 1967 base year, contributions for social insurance have outpaced all other types of taxes, reaching a fourth quarter 1984 index of 728.3. The Federal index, 741.5, is running somewhat ahead of the state-local index of 658.2.

The next highest growth since 1967 has occurred in personal income taxes, which reached an index of 547.0 in the latest quarter reported. State-local personal income taxes are now more than 10 times their 1967 base, at an index of 1,044.2. The Federal index for personal income taxes has almost quintupled, rising to 498.4. These trends reflect a long-time tendency for state-local personal income taxes to grow relative to those in the Federal sector; in 1967 personal income taxes of subnational levels of government were less than 10 percent of the amounts collected by the Federal government. By the fourth quarter of 1984, state-local personal income taxes were more than 20 percent of the Federal personal income tax take.

A similar disparity has taken place in the corporate sector of the Tax Index. The overall index in the fourth quarter of 1984 stood at 272.2 percent of the 1967 base, reflecting a moderate 231.8 index at the Federal level, in contrast to a 762.0 index for states and localities. This differential rate means that state-local corporate profits taxes have risen from about 8 percent of the Federal sector's taxes in 1967 to almost 27 percent currently.

At an overall index of 420.4 percent of the 1967 base, indirect business taxes have also been rising more rapidly at the state-local level. The state-local index of 465 in the fourth quarter of 1984 compares with an index of 311.7 at the Federal level.

The index for all other taxes combined, which covers estate and gift and personal property levies, has shown more restrained growth, reaching a 254.4 index in the final quarter of 1984.

The accompanying table provides additional details for the Tax Index and its Federal and state-local components, in comparison with trends in output.

Fall Seminar Planned

A Tax Foundation Seminar on the taxing of fringe benefits will be held on **Tuesday, September 10, 1985, in Atlanta, Georgia**, at the Ritz-Carlton Hotel—Buckhead.

Further details and reservation information will appear in *Tax Features* or call the Tax Foundation at 202/822-9050.

(HIGH/LOW EARNERS, from page 1)

number of persons with adjusted gross incomes of \$1,000,000 or more. There were 11,526 taxpayers in this top group in 1983, up nearly six times from 2,041 in 1978. They paid an average 1983 tax of \$886,774 (almost 50 percent of taxable income).

The table on page 1 provides further details.

FEDERAL TAX POLICY MEMO

MAY 1985

Editor: Edward A. Sprague, Vice President-Tax and Economic Affairs

Some Second Thoughts on Indexing

Some Tax Foundation members will recall our Federal Tax Policy Memo which was issued as a separate publication on a regular basis from 1978 to 1982 and sporadically since then. We have decided to revive this piece and extend its circulation by including it as an insert in most issues of Tax Features.

As indicated by its title, Federal Tax Policy Memo will focus on current tax issues in an analytical and hopefully understandable manner. We will go light on the statistical tables although not promising never to use them. We hope to provide some useful observations on tax reform, tax burdens, budget policy and other such matters that the Congress and Treasury are, and will be, grappling with in our capital city. Reader suggestions and comments are most welcome and may be addressed to the Editor, Federal Tax Policy Memo.

This year marks the start of indexing the Federal personal income tax for inflation. The rate brackets and personal exemptions are now adjusted to remove the effect of inflation as measured by the increase in the consumer price index (CPI) from October 1983—September 1984 over the previous 12-month period. That means a 4.1 percent factor applying to 1985 withholding tables as of January 1, 1985.

As reported in the November-December 1984 *Tax Features*, indexing is expected to save individual taxpayers \$8-10 billion in calendar 1985, with the largest percentage benefit going to middle-income taxpayers. The dragon of bracket creep has been slain! Presumably there is some rejoicing in the ranks.

In the meantime, the Treasury Department has been busy putting together a plan for vast expansion of tax indexing throughout the economy for capital gains, interest, depreciation and inventories. The revenue impact of such indexing would be very substantial even if inflation itself remains in the relatively modest 4-5 percent per year range. The revenue impact, of course, must be considered in the context of base-broadening measures in the reform plan designed to increase revenues and balance the overall program.

Over on the budget expenditure side there are new efforts to restrain the cost of indexing entitlement programs. The Administration/Senate budget proposal for fiscal 1986 for the first time would set across-the-board limits on automatic benefit increases under Social Security and Federal entitlement programs—in effect, reducing the

inflation adjustment by two percentage points. The cumulative impact of this for fiscal 1986-88 would be budget savings of approximately \$28 billion (with the inflation trend projection of about 4 percent a year under the Administration's original budget assumptions). Already, of course, there are instant warnings of hundreds of thousands of elderly being thrown back under the poverty line and other political rumblings that could derail such a bold move. But the logic of restraint here is compelling—both in terms of the deficit problem and sound long-term policy. Eventually, it should prevail.

Indexing for entitlement benefits and indexing for taxes have distinctly different rationales. The former is a deliberate attempt to shield a segment of the population—mainly retirees—from the effects of inflation. The latter aims to correct for the *unintended* impact of inflation interacting with the progressive rate structure of the income tax and historic measurement of income. More broadly, tax indexing aims to eliminate the unlegislated tax increase that has occurred because of the interaction of inflation and the tax structure, thus forcing Congress to make more explicit policy decisions with regard to both taxes and expenditures. Supporters of indexing refer to it as an "honesty in budgeting tool." But, particularly if inflation adjustment limits are set for entitlements to bring them under better budget control, new questions are going to be asked about the extent of tax indexing, too.

CPI Minus Two

There was proposed legislation in the 98th Congress to limit the Social Security and Federal retirement cost-of-living adjustments (COLAs) to inflation rates *above* the first two or three percentage points of the CPI. There have been repeated proposals to delay COLA adjustments for six months or even a year. The mechanics of the present proposal give a little better break to beneficiaries by guaranteeing a two percent inflation adjustment and allowing almost full adjustment if inflation reignites to double digits but continuing the restraint program over a more sustained period. This would result in quite significant future budget savings regardless of the specific rate of inflation (assuming it will stay above three percent). The projected COLA savings in fact are the single largest item in the Administration/Senate deficit reduction plan next to reduction in defense from the earlier budget base line.

The longer term financing problems of Social Security were addressed by the 1983 legislation which increased payroll taxes and made some payments to beneficiaries indirectly subject to income tax liability. But we clearly have run out the string on payroll tax increases to keep the system actuarially sound. Fortunately, this is not a problem for OASDI right now. In fact, the OASDI funds are building substantial surpluses and these surpluses, being invested in Federal securities, help absorb a significant part of the Federal deficit. The cumulative effect of a limit on COLA adjustments would be felt in all future years continuing to help build the fund surplus or even holding forth the future opportunity for lower payroll taxes. Don't hold your breath on that, but at least relief from any further rate increase in this obnoxious tax on employment—and serious obstacle to new hiring—should be most welcome.

Finally, there is still substantial doubt that the CPI accurately measures the impact of national inflation on the economic welfare of consumers. Most likely that effect is still exaggerated by the CPI, lacking as it does, any up-to-date means of reflecting the substitution effect. As prices rise—and particularly if they rise sharply as in the late 1970s—consumers typically revise their specific market choices eliminating frills on some items and switching to substitutes of roughly equal economic value but where prices are lower or increase in price is less marked. Even though the market basket of CPI items is periodically revised, there is simply no way to measure this constant substitution in a national index used for so many critical purposes. Two percentage points of the rate probably is a pretty good proxy, however, particularly at four percent or more inflation. In double-digit inflation the substitution effect is undoubtedly larger. But in any event, the latest CPI-minus-two proposal for limiting COLAs would seem to represent as fair as possible a reflection. At very low rates of inflation there is little substitution, and there would be a two percent COLA anyway. If inflation heats up, beneficiaries would still be protected from all but a small part of the nationally reported inflation rate.

Tax Indexing—Should The Train Slow Down?

The bet here is that if we do get an effective limit on entitlement COLAs, the same thing will be applied to indexing of the personal income tax in short order. The elemental politics of the situation would seem to dictate this, not to mention the potential budget savings.

But even while the Treasury has been proposing an expansion of tax indexing throughout the economy, there are other good reasons for going slow on the overall concept. One is fairly obvious. If through tax reform we do achieve a significant reduction and compression of the individual rate structure bringing the top rate down to at least 35 percent and enacting a

sizable increase in the personal exemption at the same time, there would be less concern about bracket creep, regardless of the inflation rate and the extent of indexing. It would simply be less important. In fact, the Bradley-Gephardt reform proposal would repeal the personal income tax indexing, thereby picking up some revenue to balance the rate reductions in future years.

Indexing on the Business Side

On the business side, Treasury makes its case for indexing depreciation, capital gains, interest and inventories mainly on the basis of better measurement of income and removing the distorting effects of inflation from investment decisions. There is certainly some economic justification for this approach which could become more compelling if inflation really heats up again. But there are also a lot of practical problems involved, including serious problems in tax planning. At this writing, the specific recommendations of Treasury II are not known, but our working assumption is that the indexing proposals will be cut back. Congress seems unlikely to agree to interest indexing in any event. Significantly, interest indexing according to the original Treasury plan would be a large revenue loser because of the \$5,000 exemption from indexing interest deductions of individuals and as long as the private sector as a whole remains in a large net creditor position. Treasury estimates the revenue impact for both individual and corporate sectors at –\$18 billion in the first full year of effect. What will evolve for depreciation and capital gains indexing will depend largely on the extent to which modifications are made in the basic depreciation proposal (Real Cost Recovery System) and whether or not capital gains are to be treated as ordinary income.

Tax indexing may well be making a contribution to more open and explicit budget decisions. Congress can no longer hide behind the hidden tax of inflation, at least as it operates through the personal tax structure. But there remains a good deal of uneasiness about it. Does insulating more and more of the private sector from inflation really make for better economic performance or will the primary result be to relax our guard against inflation by making it easier to live with? This is still a very good question even with "modest" inflation around 4 percent.

Since 1979 the monetary authorities have made a strong commitment to anti-inflationary policy. This has more than offset loose budget policy and reduced inflationary pressure in the economy. It would be a shame, to say the least, if the price of that policy, including the sharpest postwar recession on record, were to have been paid in vain.

The Minimum Tax

It probably was inevitable. Once Congress got seriously involved with the unpleasant business of budget reductions, it surely would start scratching around for less unpleasant alternatives; and high on that list, as usual, is a minimum tax on corporations. What better way to pluck the goose with the least effective squawking? Current talk is of a stiff new minimum tax that would raise \$5-\$10 billion a year from "economic income" of the corporate sector that allegedly does not pay its fair share of taxes now. There is also talk of tightening the minimum tax on upper income individuals to raise new revenues and discourage tax shelters.

A minimum tax can be crafted in several ways. It can be a true alternative tax such as is now applied to individuals whereby the taxpayer pays the higher of the regular or minimum tax. Or it can be an add-on tax such as the present corporate minimum tax whereby the taxpayer is allowed deductions from the minimum tax base such as regular tax liability, but still could end up with liability for both minimum and regular taxes. In the typical minimum tax proposal now being discussed, the tax base is composed of regular taxable income plus "preference items" which currently are not subject to tax in whole or in part. Credits usually are not allowed against minimum tax liability except for the foreign tax credit. The result tends to diminish the value of the preferences for some taxpayers but not for others if it is a true alternative tax or there is a large enough deduction for regular tax payments. However it is done, the minimum tax inevitably becomes a messy and complicated feature of the Code. Simplification it is not.

The Present Corporate Minimum Tax

The present corporate minimum tax adds back into the base such items as the excess of accelerated over straight-line depreciation, the preference for long-term capital gains, the excess of depletion deductions over the basis of property, and a few others. Approximately ten thousand corporations now pay the minimum tax, but virtually all other large corporations must compute it anyway to make sure they do not have any tax liability. The new proposals mostly would build on this approach by adding more preference items to the base and stiffening its impact. Most, however, are proposed as an alternative tax rather than the add-on form. Typical of them is S.956 introduced by Senators Daniel Patrick Moynihan (D-NY) and John H. Chafee (R-RI), which would impose a 15 percent alternative tax on corporate income above \$100,000, including in the base 22 so-called preference items such as accelerated depreciation in excess of "economic" depreciation, research and experimental expenditures, intangible drilling costs and the tax benefit in the use of the completed

contract method of accounting. This bill also would set up a stiffer new alternative minimum tax on individuals with income over \$50,000.

Significantly, some changes under the 1984 Deficit Reduction Act (DEFRA) have helped set the stage for new minimum tax proposals. That act redefined the calculation of earnings and profits (E & P) of corporations to sweep in more "economic" income and make it more difficult for corporations to declare non-taxable dividend distributions. Several of the preference income items in new minimum tax proposals are so defined by simple reference to the new E & P rules which, of course, greatly speed up the drafting chore. In addition, the new E & P base also makes for a handy reference for new taxes generally on the corporate sector. One such proposal is S.953 by Senators George J. Mitchell (D-ME) and Chafee which would set a low rate tax on all large corporations based on corporate E & P to help finance industrial pollution cleanup. This corporate "contribution" to the superfund would be made whether or not the taxpayer had any responsibility for pollution.

Diminished Corporate Tax Share

The continuing interest in the minimum tax is driven in large part by the barrage of comment and criticism as to the shrinking share of Federal receipts paid by the corporate sector in income taxes. This is a long-term phenomenon, of course. Pre-World War II, the Federal corporate income tax generally provided more revenue than the individual income tax and even in the late 1950s accounted for about 30 percent of all receipts. Since then the corporate income tax share has shrunk fairly steadily to a low of 6 percent in fiscal 1983 before rebounding to an estimated 10 percent, with the recovery in corporate profits in fiscal 1985. The long-term decline is associated with two trends having nothing to do with corporate tax policy: a corresponding secular downtrend in gross corporate profit margins (profits as a percent of national income) and the very sharp rise in Federal payroll taxes displacing the relative importance of all income taxes. Then too there have been more liberal capital recovery and other provisions which certainly have whittled away at the corporate tax base especially in recent years. In absolute dollars Federal corporate tax receipts have risen substantially with only business cycle interruption, to an estimated new peak of \$74 billion in fiscal 1985.

None of this really should have much bearing on what the corporate tax burden should be. As corporations themselves are incapable of bearing the real incidence of any tax, the decision to impose taxes on the corporate form should stem from considerations of effi-

ciency and limiting the shelter opportunities of individuals. In the public perception, however, the corporate sector is getting away with murder, and this is reinforced by press stories on corporations with significant "economic income" but little or no tax liability.

A Flawed Concept

Superficially the corporate minimum tax may seem to be an attractive way to make a dent in the deficit and at the same time attempt a fairer distribution of corporate tax liability. But the concept is flawed. The existing minimum tax was brought into the Code as an afterthought by a Senate amendment to the 1969 Tax Reform Act without any serious consideration as to its place in the corporate tax structure. The original Treasury papers and studies which gave rise to most of the provisions of the 1969 Act recommended *against* a corporate minimum tax on the basis that it could not take into consideration the particular circumstances and problems of different economic sectors calling for particular tax treatment. That is precisely the problem with the existing minimum tax which has had most of its impact on companies and industries with low earnings in depressed markets.

Even if one is taken with a notion of enforcing a fairer distribution of corporate tax liability, the minimum tax approach could have a capricious and uneven impact. Its revenue yield to a large extent could depend on retroactive application to most investments entered into without calculation of a minimum tax liability. In some minimum tax plans the foreign tax credit is allowed as a full offset against the minimum tax. In others it is not, even though the purpose of the credit is to avoid double taxation of earnings and it is not considered a preference

income item by tax professionals. Virtually all minimum tax proposals would add back into the minimum tax base part of the Accelerated Cost Recovery System (ACRS) depreciation deduction, either the excess of ACRS over straight line or over "economic" depreciation. This would diminish the utility of ACRS without posing an alternative depreciation system.

No True Solution

A minimum tax addresses all of the add-back items indirectly almost stealthily, robbing them of the intended full impact without confronting squarely the issue of their need in terms of national policy objectives. This is the antithesis of meaningful tax reform and, of course, hardly squares with the simplification objective of reform.

All of the major tax reform proposals under current consideration would make substantial changes in the business tax provisions affected by the typical minimum tax proposals. Some interests, of course, may feel they would be better off with the partial hit of the minimum tax rather than the full bore of tax reform. Others see the minimum tax as more politically attractive. But the reform plans attempt at least to come to grips with the reasons for the particular tax provisions proposing modifications or alternatives, particularly in the areas of capital recovery, capital gains and foreign source income. The reform plans also offer the inducement of significantly lower rates. Both the original Treasury plan and the Bradley-Gephardt plan, incidentally, would repeal the existing corporate minimum tax as a redundant and unnecessary complication of the Code.

Pace of Federal Grants Slows Sharply Since '81

The Federal government disbursed \$92.8 billion in grants-in-aid to state and local governments in fiscal year 1984, 4.5 percent (\$4.0 billion) more than in fiscal 1983, according to Tax Foundation economists.

After growing at annual rates averaging 15 percent during the 1970s, the pace of grant giving has slowed sharply since 1981. Fiscal 1984 levels were only about \$218 million higher than in 1981. (This fact highlights the lasting impact of a \$7.0 billion reduction in grants-in-aid from 1981 to 1982—part of a spending rollback unprecedented in recent peacetime history.)

The Administration projects modest growth in fiscal

1985, followed by significant reductions in future years, say analysts at the Washington-based tax watchdog organization.

Medicaid, interstate highway construction, Aid to Families with Dependent Children, subsidized housing, and general revenue-sharing comprised the five largest Federal grant programs in 1984. Together they accounted for more than 51 percent of the grants disbursed, a total of \$47.8 billion.

Residents of 19 states, whose Federal tax burdens exceeded the amount of grants received by their respective state and local governments, footed the bill for the

(Continued on page 4)

THE FRONT BURNER

By Robert C. Brown
President
Tax Foundation, Incorporated

"With All Deliberate Speed . . ."

From the perspective of those interested in legislative efficiency, the 99th Congress seems to have hit the ground stumbling. When President Reagan delayed publication of his Budget for Fiscal Year 1986, Senate Majority Leader Robert Dole (R-KS) declared that he would have a budget ready for a vote on February 8.

February 8, March 8, April 8, and May 8 came and went. Still no Budget vote. Finally, in the early morning hours of May 10, the Senate committed itself to a budget compromise promising \$56 billion in savings next year and about \$100 billion over three years—within the limits being touted as a must to reassure a jittery financial community that Washington is serious about getting its fiscal act together.

The proposal arrived with the usual melodramatics and hoopla. Presidential phone calls to wavering Senators. A rush back to Washington by Vice President Bush, whose tie-breaking vote was, indeed, needed. There was even an extra fillip of drama—part Mack Sennett and part "Profiles in Courage"—as an ambulance brought convalescent Senator Pete Wilson (R-CA) from Bethesda Naval Hospital to beef up the ranks of supporters. Wilson, recovering from emergency surgery for removal of a ruptured appendix, arrived on the Senate floor in a wheelchair to a round of applause and cheers from his healthier colleagues.

As is customary, the Senate program spreads a thin veneer of painful cuts over the widest possible population and leaves most of the pork in the barrel, lest any constituency leave the table too hungry. But it was a start on essential fiscal restraint.

The House must now, of course, do its ritual dance. The members must walk the tightrope of loyalty to their own constituencies on the one side and appear not to stand in the way of much needed deficit reduction on the other. We can assume there will be an equivalent amount of "Sturm und Drang" but hope that, like a Wagnerian opera, the Valkyrie of fiscal responsibility finally will ride to the rescue—probably in another late-night, "Perils-of-Pauline" climax.

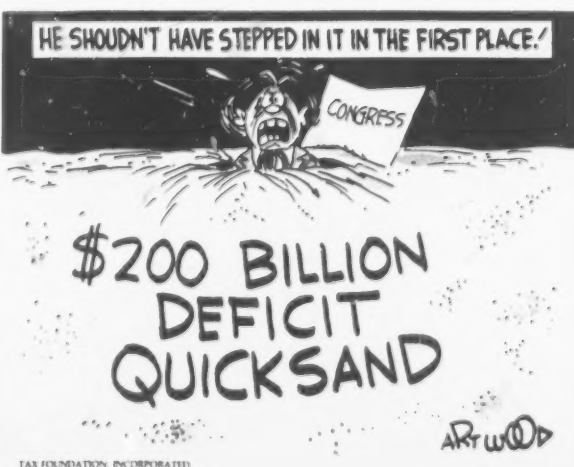
If this weren't so important, it would be ludicrous. However, let's not be too judgmental when the U.S. Congress acts like the Katzenjammer Kids. After all, our Founding Fathers could have pushed through a strong central government. Some of them favored naming George Washington king in the heyday of his victory over Cornwallis.

Instead, they took the approach that a government is best when it governs least. Their first solution—the Articles of Confederation—managed the common affairs of the new nation so poorly that our progenitors had to sit in plenary session yet again and hammer out our present Constitution.

Hence, it is no accident that the national government stumbles and bumbles, hems and haws. The patriots who threw off the yoke of one tyrant (to borrow their own view of what they had done) deliberately created a Federal system that would be hard put to ride roughshod over their future generations—ever.

When tempted to berate the people we have elected to lead us, it is well to remember that we get the kind of government that we deserve. It is also well to recall that dictatorship is the most efficient form of government. Given that choice, I'll take inefficiency any day.

"The Senate program spreads a thin veneer of painful cuts over the widest possible population and leaves most of the pork in the barrel."



TAX FOUNDATION, INCORPORATED

(GRANTS-IN-AID, from page 3)

grant programs going to all 50 states and the District of Columbia.

The 131 million persons residing in these "paying" states bore 58 percent of the tax costs—\$53,838 million—to support the programs, while their state and local governments received \$44,254 million in Federal grants-in-aid. The average tax "cost" per dollar of Federal aid was \$1.22.

On the other hand, the 105 million residents of the other 31 states and the District of Columbia paid an average of 80 cents in Federal taxes for each dollar of Federal grants. These "receiving" states sent \$38,922 million in taxes to Washington and received back Federal aid worth \$48,506 million.

**Federal Grants-in-Aid to State and Local Governments
and Estimated Federal Tax Burden for Federal Grants**
Fiscal Year 1984

State	Grants ^a (millions)	Percent of total tax burden	Estimated tax burden for grants ^b (millions)	Tax burden per dollar of aid Amount	Rank
TOTAL U.S.	\$92,759.2	100.00	\$92,759.2	\$1.00	—
Alabama	1,493.9	1.28	1,187.3	.79	35
Alaska	591.4	.35	324.6	.55	48
Arizona	973.7	1.13	1,048.2	1.07	16
Arkansas	937.7	.71	658.6	.70	41
California	9,686.3	12.02	11,149.7	1.15	10
Colorado	1,097.9	1.47	1,363.6	1.24	7
Connecticut	1,221.4	1.84	1,706.8	1.40	3
Delaware	298.5	.29	269.0	.90	25
Florida	2,779.4	4.53	4,202.0	1.51	2
Georgia	2,209.4	2.10	1,947.9	.88	28
Hawaii	458.8	.44	408.1	.89	27
Idaho	393.0	.32	296.8	.76	36
Illinois	4,303.1	5.38	4,990.4	1.16	9
Indiana	1,759.5	2.11	1,957.2	1.11	12
Iowa	1,090.7	1.11	1,029.6	.94	22
Kansas	802.8	1.08	1,001.8	1.25	6
Kentucky	1,577.2	1.20	1,113.1	.71	40
Louisiana	1,770.8	1.71	1,586.2	.90	26
Maine	590.3	.39	361.8	.61	45
Maryland	1,718.6	2.09	1,938.7	1.13	11
Massachusetts	2,634.0	2.81	2,606.5	.99	20
Michigan	3,773.4	3.72	3,450.6	.91	23
Minnesota	1,862.2	1.75	1,623.3	.87	29
Mississippi	1,154.3	.71	658.6	.57	47
Missouri	1,771.7	1.99	1,845.9	1.04	17
Montana	486.1	.30	278.3	.57	46
Nebraska	636.2	.62	575.1	.90	24
Nevada	319.8	.42	389.6	1.22	8
New Hampshire	367.0	.43	398.9	1.09	13
New Jersey	2,871.0	4.18	3,877.3	1.35	5
New Mexico	664.0	.49	454.5	.68	43
New York	10,268.3	8.31	7,708.3	.75	37
North Carolina	1,926.5	2.09	1,938.7	1.01	18
North Dakota	429.9	.29	269.0	.63	44
Ohio	4,043.8	4.37	4,053.6	1.00	19
Oklahoma	1,161.1	1.35	1,252.2	1.08	15
Oregon	1,122.4	1.01	936.9	.83	32
Pennsylvania	4,665.6	4.95	4,591.6	.98	21
Rhode Island	547.6	.41	380.3	.69	42
South Carolina	1,165.3	1.03	955.4	.82	34
South Dakota	431.8	.23	213.3	.49	50
Tennessee	1,777.6	1.65	1,530.5	.86	30
Texas	4,130.5	7.16	6,641.6	1.61	1
Utah	652.3	.52	482.3	.74	38
Vermont	330.8	.18	167.0	.50	49
Virginia	1,646.2	2.45	2,272.6	1.38	4
Washington	1,673.2	1.95	1,808.8	1.08	14
West Virginia	818.1	.63	584.4	.71	39
Wisconsin	2,062.8	1.86	1,725.3	.84	31
Wyoming	270.5	.24	222.6	.82	33
District of Columbia	1,340.8	.36	333.9	.25	51

^aExcludes shared revenues and payments in lieu of taxes; includes General Revenue Sharing and trust fund aids.

^bThe total tax burden for grants is assumed to equal grant payments.

Source: U.S. Department of Commerce, Bureau of the Census; and Tax Foundation computations.

For the fourth year in a row, Texans paid the highest tax premium for Federal grants. Each dollar of grants cost them \$1.61 in Federal taxes. Other top paying states were Florida (\$1.51), Connecticut (\$1.40), Virginia (\$1.38), and New Jersey (\$1.35).

At the low end, residents of the nation's capital paid 25 cents in taxes per dollar of Federal aid. Favorable balances also existed in South Dakota (49 cents), Vermont (50 cents), Alaska (55 cents), and Mississippi (57 cents).

Tax Foundation's method for deriving the Federal tax burdens borne by residents of each state is designed to show where tax dollars actually originate, rather than where they are collected. The data on grants-in-aid are shown as reported by the Bureau of the Census.

Tax Foundation analysts point out that these comparisons of Federal tax burdens for aid assistance do not reflect the entire costs incurred by state and local governments for obtaining grants. The comparisons, with few exceptions, do not take into account the costs to these governments of administering the programs for which the aid is granted, nor the amounts of matching funds which the state and local governments must make available out of their own revenues in order to qualify as recipients of these grants. In fiscal year 1984, Foundation economists estimate that state and local governments provided about 48 cents of matching funds for each \$1.00 of Federal aid.

The accompanying table provides state-by-state data.

Further details are provided in the "Memorandum on the Allocation of the Federal Tax Burden and Federal Grants-in-Aid by State, Fiscal Year 1984," available from Tax Foundation for \$1.00 (plus \$1.00 postage and handling per order).

International Tax Seminar

Tax Foundation will sponsor a Seminar on "Tax Reform Implications for International Business" on Tuesday, June 4, 1985, at the Washington Plaza Hotel in Washington, D.C.

This seminar is designed for those concerned with the tax treatment of foreign source income in the context of overall tax reform proposals. It will cover proposed changes in the foreign tax credit, Section 936 relating to possessions corporations and other foreign source income issues.

Speakers at the Morning Session, which runs from 9:30 a.m. to 12:30 p.m., will include:

- J. Roger Mentz, Deputy Assistant Secretary of the Treasury
- Robert J. Patrick, Jr., Washington Director, International Tax Practice, Price Waterhouse and Co.
- Norman B. Ture, President, Institute for Research on the Economics of Taxation
- Leslie Cookenboo, Coordinator of Economic Policy, Exxon Corporation
- Frederick L. MacDonald, Assistant General Tax Counsel, General Motors Corp.

The Luncheon Session will feature The Honorable Sam Gibbons, Chairman, Subcommittee on Trade, and Member, House Committee on Ways and Means.

The registration charge is \$135 per registrant. For further information or to register, call the Tax Foundation at 202/822-9050.

TAX·FEATURES

Government Spending Tops \$1.58 Trillion; Now Totals \$18,310 for Each U.S. Household

"Income Security" Claims 1/3 Of All Public Dollars Spent

Major social welfare programs in the United States claimed nearly 34 cents of every dollar spent by Federal, state, and local governments in fiscal year 1983 (latest data available). The costs of these programs came to \$455 billion out of a spending total in excess of \$1.3 trillion—33.7 cents of every dollar of government spending.

Per U.S. household, spending for these programs amounted to \$5,419. Total government spending per household was \$16,099.

The second most costly category in fiscal 1983 was national defense and international relations, at 16.9 cents on the dollar. Next came education (13.1 cents) and interest on general debt (9.8 cents). Per household, defense and international spending totaled \$2,726; education, \$2,105; and interest, \$1,583.

The Federal social security system (OASDHI) is by far the largest among the major social programs. It accounted for 16.4 cents of each public expenditure dollar in 1983. Also included in the grouping are social services and income maintenance (public welfare, health and hospitals, and unemployment insurance benefits); veterans' programs that are not classified under other functions; railroad retirement; and government employee retirement. The sum of these major programs understates the size of the social welfare "spending total," broadly defined in that it excludes public education (shown separately), as well as subsidized housing and many veterans' programs for which the data are not segregable from other groupings, according to Foundation researchers.

Growth in the social programs has outdistanced that of other government programs by a wide margin. In 1983, social welfare spending was 14 times what it was in 1960, while other programs grew to only 7.5 times their size over the same two decades. The 33.7 cents per dollar share of all spending held by social programs in 1983 reflected a rise from 20.6 cents in 1960 and from 25.8 cents in 1970.

Costs for national defense and international programs in 1983 came to about half of the social welfare total, at 16.9 cents per dollar of all public spending.

While education received a somewhat higher share of public funds in 1983 than in 1960, its 13.1 cents per

(Continued on page 4)

Federal, state, and local governments will spend \$6,670 for every person in the United States (\$18,310 per household) in the current fiscal year, according to the Tax Foundation. Total outlays will top \$1.58 trillion. At this level, government outlays this year will exceed the nation's total output as measured by gross national product just ten years ago.

Compared to last year, fiscal 1985 spending will rise by an estimated \$156.4 billion, or 11.0 percent. Federal spending is expected to increase by \$115 billion, or 12.6 percent, while state-local outlays are expected to grow by \$41.6 billion, or 8.1 percent.

On a per capita basis, government spending in fiscal 1985 is estimated at \$6,670, up from \$3,373 seven years ago. For each of the more than 86 million U.S. households, the government spending tab will come to \$18,310 this year, as compared to \$9,804 in 1978.

The Federal government accounts for about 65 percent of total public spending (\$1,026.2 billion). Since 1950, the Federal share of the rising public expenditure total has remained fairly constant. Except for the period of the Korean War, when it accounted for more than 70 percent of all spending, the Federal share has ranged from a high of 69.8 percent in 1954 to a low of 60.7 percent in 1972.

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Federal, State, and Local Government Expenditures*

Selected Fiscal Years 1950-1985

Fiscal year	Amount (billions)			Total expenditures	
	All governments	Federal	State and local	Per household	Per capita
1950.....	\$ 70.3	\$ 44.8	\$ 25.5	\$ 1,614	\$ 466
1960.....	151.3	97.3	54.0	2,866	847
1965.....	205.7	130.1	75.6	3,581	1,067
1970.....	333.0	208.2	124.8	5,252	1,643
1975.....	560.1	340.5	219.6	7,875	2,612
1976.....	625.1	389.9	235.2	8,579	2,886
1977.....	680.3	430.6	249.7	9,176	3,111
1978.....	745.4	477.8	267.6	9,804	3,373
1979.....	832.4	535.7	296.7	10,764	3,726
1980.....	958.6	615.4	343.2	11,867	4,243
1981.....	1,109.8	717.4	392.4	13,474	4,857
1982.....	1,233.5	794.7	438.8	14,768	5,345
1983.....	1,351.0	872.5	478.5	16,099	5,798
1984 ^b	1,426.4	911.4	515.0	16,701	6,066
1985 ^b	1,582.8	1,026.2	556.6	18,310	6,670

*Grants-in-aid are counted as expenditures of the first disbursing unit.

^bEstimated by Tax Foundation.

Source: Basic data from U.S. Department of Commerce, Bureau of the Census; computations by Tax Foundation.

Taxes Heaviest for Top Earners Despite '81 Cuts; Few Higher Earners Turn to Tax Avoidance Schemes

In the fading days of the Lyndon Johnson Administration, Joseph Bar, then Acting Secretary of the Treasury, made a speech calling attention to 154 tax returns in 1966 with \$200,000 or more in adjusted gross income but no Federal tax liability. It was the shot heard round the world for tax reform. Shortly afterward the drive for the Tax Reform Act of 1969 gathered steam. The new Republican Administration of Richard Nixon was caught off guard and acquiesced in a number of restrictive new provisions in the Code, including the first minimum tax. Under the 1976 Tax Reform Act, the minimum tax was stiffened considerably and other measures were adopted to force upper income individuals to pay a higher share of income taxes.

Now, along with criticism of the Reagan tax cuts of 1981 for redistributing wealth upward, there has been a renewed spurt of stories about the spread of tax shelter arrangements, despite the lower rates of tax which were supposed to discourage shelters, and on how upper income people still escape Federal income tax as a result. This sort of talk, of course, is fueling Congressional tax reform efforts and has helped prod the Administration to make quite radical proposals of its own. It's also reviving the minimum tax concept.

The Non-Payers

As one result of the 1976 Tax Reform Act, Treasury has been issuing a regular compilation of data on high income taxpayers and non-taxpayers including the importance of various tax provisions in reducing or eliminating tax liability.

The most recent data pertained to calendar 1982 with comparable statistics going back to 1966. In reviewing the record one is struck immediately by the very small proportion of actual tax escapees, at least in relation to the rhetoric of some reformers. The further you dig, in fact, in terms of the published figures, the smaller the problem looks. We hasten to add that the Statistics of Income does not, and cannot, capture the full extent of tax avoidance. More on that later. What they show is capsulized in the tables below.

The tables show that at no time in the decade ending in 1982 did non-taxpaying returns amount to more than one-half of one percent of all returns with \$200,000 or more of expanded income and since 1975 they ran less than one-fifth of one percent of such returns. Expanded income includes items of tax preference subject to the minimum tax and is the nearest

thing to "economic income" in the published statistics. In this sense, it is probably a more appropriate measure than adjusted gross income.

There are some other factors which tend to deflate the extent of reported upper income tax avoidance further. Up to half of the non-taxable returns in any given year were due to heavy tax payments abroad resulting in substantial foreign tax credits against U.S. tax liability. Most of the individuals involved were living and working abroad and use of the foreign tax credit here to avoid double taxation of income hardly seems to be a loophole.

Also in numerous cases a non-taxable return in any one year may well show up as taxable in another. The two items that have the largest impact in reducing or eliminating tax liability of the upper income groups are deductions for interest and state/local taxes. A large state tax or interest payment on back taxes can help wipe out Federal liability for one year although the individual taxpayer may pay a sizable Federal tax regularly in other years.

(Continued on page 4)

Nontaxable Income Tax Returns With Expanded Income¹ of \$200,000 or Over (1973-1982)

Returns		% of all returns in income class
1973	91	0.26
1974	167	0.39
1975	215	0.53
1976	53	0.10
1977	85	0.13
1978	105	0.12
1979	114	0.09
1980	198	0.13
1981	304	0.17
1982	299	0.14

¹Expanded means equal adjusted gross income plus items of tax "preference" less investment expense. Principal "preference" items are the excluded 60% of capital gains and excess of accelerated depreciation over straight-line on real property.

Taxable Income Tax Returns With Income of \$200,000 or Over 1982

	\$200,000 or over of Adjusted Gross Income	\$200,000 or over of Expanded Income
Returns	169,105	206,992
Average U.S. Tax Payment	\$157,439	\$138,501
Effective U.S. Rate of Tax	36.7%	27.5%
Average Tax Payment including Foreign Taxes	\$159,845	\$140,494
Effective Rate of Tax including Foreign Taxes	37.3%	27.9%
Effective U.S. Rate of Tax (% of total returns)		
Under 20%	8.0%	23.8%
20%-35%	27.7%	39.4%
Over 35%	64.3%	36.8%

"In reviewing the record one is struck immediately by the very small proportion of actual tax escapees, at least in relation to the rhetoric of some reformers."

Tax Features

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FEDERAL TAX POLICY MEMO

June 1985

Editor: Edward A. Sprague, Vice President-Tax and Economic Affairs

Tax Reform and Reagan I

While getting ready for the long, hot summer, here are some preliminary thoughts on tax reform now that Reagan I is finally out in the open:

1. Major Changes Proposed. While pulling back on a good number of the most controversial provisions in Treasury I, the President's new proposals still would constitute the most far-reaching overhaul of the Federal income tax since the 1954 Code and, perhaps, since the 1939 Code. There's lots to chew on in Reagan I. The cordial reception given to the President's proposals by the Chairman of the House Ways and Means Committee indicates Congress will take them seriously. But as always, Congress will want to apply its own tax stamp. So the sailing will not be all smooth, particularly if Congress decides to entwine tax reform with deficit reduction.

2. More Practical. Reagan I will be criticized for retreating from the fuller taxation of economic income in Treasury I. But it is hardly just a matter of caving in to the demands of special interests. There were serious concerns raised about our ability to raise capital for investment and compete abroad under provisions of Treasury I which were significantly modified by Reagan I. In other areas there were large questions about the administrability of Treasury I provisions such as on fringe benefits, entertainment expense and interest indexing. These needed to be addressed and were, although not all answered by any means.

3. Business Still Bears the Brunt. It would seem difficult to argue that the business sector is being treated with generosity under Reagan I when there is an estimated 24.5 percent increase in business tax burdens over five years compared to a 6 percent drop in individual tax burdens. There are ameliorations of business tax treatment compared to Treasury I to be sure, but there are also a new minimum tax proposal and an outright money grab through depreciation "recapture" that penalizes those who made large commitments to productive investments since 1980. In a true economic sense, of course, assuming the program is really at or close to revenue neutrality, there could be no real net "benefit" to the individual sector. As the burden of the proposed corporate tax increases ultimately would fall entirely on individuals—as shareholders, employees, or consumers—the ultimate effect on individuals would be a wash. After decades of debate we still don't know the true incidence of the corporate income tax on shareholders, workers and consumers, and in this report as in others, we resort to the shorthand of equating revenue change with change in tax burdens. In this sense, in the short term, business clearly bears the brunt.

4. Simplification. The tax simplification objective would be a little better served, at least in the individual sector, by Reagan

I than by Treasury I even though the overall thrust of the former seems to assign somewhat less importance to simplicity. The pullback on fringe benefits and indexing, in particular, would improve compliance and planning prospects. Going the other way, however, is the proposed stiffening of minimum taxes on individuals and corporations. By their very nature minimum taxes represent tax complications even with exemption levels that eliminate most taxpayers from liability.

5. Political Appeal. The Administration obviously intends to push its reform package by emphasizing the individual rate reductions and relief for families by near doubling of the personal exemption. This may be a good tactic given the public's limited attention span to the intricacies of structural reform. However, if pressed too hard, the "populist agenda" approach may invite another bidding war with Congress. In 1981 the business sector was the beneficiary of additional tax concessions as a result of the competition between the Administration and House Ways and Means Committee programs. This time it could be reversed with the business sector being subject to still higher burdens to "pay" for the liberal individual rate reduction and allowance increases, particularly if moves to broaden the individual tax base falter in Congress.

6. Economic Impact. At one point this Spring, we were told that the Administration proposals would be accompanied by a much more detailed and explicit statement of overall economic impact compared to the generalities of Treasury I. But as of this writing, the statement of impact consists of one obscure paragraph indicating that Treasury feels real GNP would run at least 1.5 percent higher by 1995 under the new program compared to current law. But because of the "inherent uncertainty" in such a forecast, this is not reflected in any revenue estimates nor is there any development of the case for economic efficiencies and better resource allocation under the overall program. In fact, other than a short summary, there is no tied-together analysis of the program at all—only descriptions of the individual provisions, as in the second volume of the Treasury I proposals. This is somewhat odd given the stated need to put the package to Congress as a whole.

Here are some further thoughts as to the major sectors of Reagan I:

Individual Rates and Structure

The President was said to be very committed to rate reduction and substantial increase in the personal exemption. It's hardly surprising, therefore, that these salient factors of Treasury I remain intact in Reagan I. The proposed three-tier rate

structure—15%-25%-35%—and the \$2,000 personal exemption are identical to those of Treasury I, while some increases over Treasury I are proposed for the zero bracket amount and the earned income credit. Also, there is a little shuffling of the brackets between Treasury I and Reagan I with the result that the 25 percent rate cuts in at a slightly lower level (\$29,000 on joint returns) and cuts out at a significantly higher level (\$70,000 on joint returns), thus widening the basic middle bracket to include the whole upper-middle income group. Essentially, however, the rate structure is the same as in Treasury I and, while many other provisions of Treasury I were massaged or emasculated, it was all done with reference to the fixed lodestar of rate compression and exemption increase. Structural changes in the base and their revenue consequences all had to fit with predetermined tax reductions.

Capital Gains

The most noticeable change from Treasury I on the individual side is the capital gains treatment. Here, heavy lobbying appears to have paid off with Treasury officials even admitting that the November 1984 proposal to tax all gains as ordinary income was wrong conceptually and that a preferred rate on capital gains was really necessary to attract venture capital and encourage productive investment. Efforts to carve out and define an exemption from ordinary income treatment for gains on risk investments were not successful—not surprisingly. Therefore, the logical compromise was to retain a capital gains exclusion high enough that when combined with rate reduction it still produces a significant capital gains differential. The specific proposal is for a 50 percent exclusion, the same as before 1978, which would yield a maximum capital gains rate of 17.5 percent compared to 20 percent now. Individuals would also be offered an indexing of gains alternative in the future. Depreciable business property, however, would have to be indexed and would not be eligible for the 50 percent exclusion. This sounds a little complicated but certainly would produce a better return for broad investment purposes than under Treasury I. Some investments, however, such as business real estate and section 1231 property (coal, timber, livestock, etc.) could face a double whammy—loss of the capital gains exclusion and disadvantage against alternative investments that would retain it.

Individual Base Broadening

There is base broadening in Reagan I, but, for revenue purposes, 40 percent of it is accounted for by simply striking state/local taxes as a deduction. The table below indicates the revenue impact of all other proposed increases in the individual tax base compared to elimination of the state/local tax deduction. Little wonder then that the Administration is taking a hard-nosed, no-negotiation stance on the state/local deduction. Without its repeal the hope for rate reduction is decimated, particularly considering the likelihood of Congressional softening of other base-broadening proposals.

Despite complaints from the high-tax states *most* taxpayers in all income groups would get some net benefit from the President's program, even in New York, Massachusetts, District of Columbia, etc. What the Governor of New York and some others seem to be really worried about is their increased

Estimated Revenue Pickup in Fiscal 1990 Under Reagan I (\$bil)

Repeal second earner deduction	9.0
Taxation of fringe benefits	6.9
Tighten treatment of business entertainment expense, correct other "abuses"	2.3
Repeal income averaging and other "simplification"	7.6
Depreciation changes (individual only)	6.1
Repeal ITC (individual only)	7.2
Retirement savings changes	5.8
Repeal \$100/\$200 dividend exclusion	.7
Tighten treatment of specific "subsidies" and tax shelters of individuals	13.9
Subtotal	59.5
Eliminate deduction for state/local taxes	40.0
Total	99.5

exposure as high-tax places without the Federal deduction and the potential comparative disadvantage thereto. To the extent that Federal base broadening will automatically increase the base of state income taxes (most of them piggybacking on the Federal structure) the states could adjust their own income tax rates downward to lessen the impact of losing the Federal deduction without necessarily having to cut state services. In any event, Congress probably is going to have to buy repeal of both the state/local deduction and the two-earner deduction if it intends to carry through on rate relief of the magnitude proposed.

What will ensue for all the other base-broadening proposals is much harder to assess. Many of them involve obscure areas of the Code (tightening the grantor trust rules, for example) or would make changes in areas where powerful lobbies are ready to pounce (such as eliminating industrial revenue and mortgage subsidy bonds and the business meal restrictions). But, collectively, these proposals would provide for about one-half of the total base-broadening objective for individuals. Once again, Congress would have to make some real headway here in order to justify the rate reduction.

Distribution of Individual Tax Burdens

The tax burden table accompanying Treasury I showed no change in the portion of the tax paid by different income groups compared to current law (except for the very lowest whose share was reduced). Reagan I, on the other hand, does indicate some shift in burdens with a slightly higher load on the middle and upper-middle income groups (\$50,000-\$100,000 in particular), a slightly reduced share at the very top (over \$200,000) and a more marked reduction in the tax share of those under \$20,000. The shifts in the upper range do not seem to stem from any overall plan but rather are the result of the "givens" on the rate structure and compromises on capital gains and other provisions of Treasury I that were reworked for various reasons. The net is to allow relatively more tax relief at both ends of the income scale and to skew the distribution of burdens somewhat. Although the latter effect is not particularly significant in substance, inevitably it will be seized upon by the program's detractors.

Another distribution point: The President's program is said to benefit—that is to reduce the taxes of—58 percent of all families and raise taxes on only 21 percent. The implication is that that 21 percent are not paying a fair share now and they are

mainly in the upper-income groups who would be hit by tighter rules on tax shelters, the stiffer minimum tax, etc. However, there could be some individual losers throughout the middle-income groups, particularly those who have taken heavy state/local tax deductions and were beneficiaries of such mundane provisions as the two-earner deduction and/or occasional use of income averaging.

Capital Recovery and Corporate Rates

"Crackers" is the latest word in the capital recovery field which seems to be more productive of slogan-acronyms than any semblance of stable tax policy. The latest proposal is the Capital Cost Recovery System (CCRS) which obviously is more generous than the Treasury I plan (RCRS) but more restrictive than current law ACRS with the investment credit. The investment credit would be repealed under Reagan I, and the proposed transition rules are very stingy. CCRS or "Crackers" itself is described as retaining the shell of economic depreciation of the Treasury I plan but adding back some front-loading of ACRS. With both indexing and some acceleration, CCRS is said to produce the same or lower overall cost of capital as under current law. But without the investment credit, equipment investments clearly would be worse off unless inflation zooms into double-digit ranges. Structures would benefit more under CCRS. As in Treasury I, the basic corporate income tax rate would be cut to 33 percent. Graduated rates for small businesses below 33 percent would be retained.

Business reaction to the CCRS proposal has been positive. But many were shocked by the unexpected depreciation "recapture" scheme. This would recoup the so-called "windfall" on investments made under ACRS with the expectation of a 46 percent top corporate rate but which under Reagan I would be subject to a 33 percent rate. The difference would be recaptured by taxing away 40 percent of the excess of accelerated depreciation over straight line since 1980. Payments would be spread over three years and the rule would apply even if the assets were not sold or otherwise disposed of. While the Treasury has a plausible case as to the existence of some windfall on past investment under a 33 percent rate, this type of retroactive cost recapture certainly has not been a feature of our tax system. Its impact, moreover, would be heaviest on those who invested the most in productive plant and equipment under the mandatory depreciation provisions of the Economic Recovery Tax Act of 1981 (ERTA). The objective of that legislation was to encourage such investment and now, four years later, businesses that actually pursued a stated national objective would be penalized quite severely for so doing. A rather awkward stance for business tax policy to say the least.

The windfall recapture theoretically would apply to individuals, too, but with a \$400,000 threshold on total depreciation taken and a \$300,000 exemption of excess depreciation, very few individuals would be affected. This appears to be a last-minute grasp for additional revenues—approximately \$57 billion in the fiscal 1986-1989 period—from the business sector, occasioned, reportedly, by a shortfall in the overall revenue estimates of the program just before its release.

Other Business Provisions

Most of the other major provisions of Treasury I affecting the

business sector were carried over in Reagan I, some with quite substantial modifications. Interest indexing, however, was dropped entirely as too costly and too complicated.

The Treasury I proposal for a 50 percent dividends paid deduction was cut way back to 10 percent, apparently for revenue considerations. While it is nice to see at least some recognition of the problem of double taxation of corporate earnings remaining in the program, a 10 percent deduction is pretty meager relief. The danger is that Congress will view it as relatively unimportant. Without stronger sponsorship it's unlikely to survive at all.

Much more restrictive rules with respect to multiperiod production cost accounting, heavily impacting a range of capital intensive industries, were carried over in Reagan I as were proposals to force multinational firms to use the per country limitation on the foreign tax credit and more restrictive sourcing rules for income and deductions. The President's program does make some adjustment from Treasury I in proposed treatment of foreign source income including a five-year grandfather clause for continued use of the section 936 credit applying to investment in Puerto Rico. But the thrust of the new foreign income proposals is still to produce more revenue—and severe complications for tax planning without much concern as to the U.S. multinationals' ability to compete abroad, particularly in low-tax countries.

Finally, there is the tightened corporate minimum tax proposal. The Administration justifies this as a means to ensure that all corporations with economic income will pay some tax. Because Treasury I's reach over economic income has been diluted, the offer to repeal the corporate minimum tax has been withdrawn. Obviously the Administration is responding to current political pressure in this area. While its new minimum tax proposal is pretty minimal in terms of revenue considerations, Congress is waiting in the wings with much stiffer measures.

From a tax policy view there is little good to be seen in the minimum tax concept for either corporations or individuals. As Senator Bill Bradley (D-NJ) said, "A minimum tax is an admission of failure. It demonstrates not only that the system is broke, but also that Congress doesn't have the guts to fix it." Minimum taxes also can have untoward economic consequences and surely would further complicate the system (see May 1985 *Tax Features*). But they are perceived as powerful political tools to make the system look "fairer."

The table on page 4 indicates the magnitude of the major shifts in business tax proposals between Treasury I and Reagan I. These are expressed in terms of estimated revenue consequences for the five fiscal years 1986-1990, compared to current law. These revenue estimates, of course, are on a static basis assuming no change in business behavior which is unrealistic. They are shown mainly to portray the policy directions. Revenue estimates on the effect of reducing corporate rates assume all other provisions are enacted, while the revenue effects of the other provisions assume current law rates.

As a postscript to the Economic Recovery Tax Act of 1981 (ERTA), it is interesting to remember all the froth about the deep business tax cuts that year "destroying" the corporate income tax. Since then the 1982 and 1984 acts "took back" over 85 percent of ERTA's corporate tax relief scheduled for the fiscal 1981-1990 period as a whole. Now, of course, we have

Change in Estimated Revenues Major Corporate Tax Provisions, Fiscal 1986-1990

(\$bils)

	Treasury I	Reagan I
Corporate rate reduction to 33%	-203.8	-154.0
Small corporations' graduated rates	+ 31.2	- 2.0
Economic depreciation	+180.5	+ 26.0
Repeal investment credit	+123.9	+139.7
Depreciation recapture	—	+ 56.5
Dividends paid deduction	- 97.7	- 24.8
Interest indexing	- 15.3	—
Multiperiod production cost accounting ..	+ 41.5	+ 39.7
Percentage oil depletion and intangible drilling costs	+ 32.9	+ 2.1
Financial institutions	+ 54.8	+ 23.8
Section 936 credit	+ 3.7	+ 0.3
Other foreign source income	+ 15.3	+ 18.5
Overall corporate provisions ¹	+164.9	+118.4

¹Includes others than listed above.

exactly the opposite direction with large corporate tax increases in the works and the corporate income tax slated for a 20 percent share of all Federal income, estate and gift, and excise taxes compared to 14 percent in the 1982-1984 period.

Revenue Neutrality and Transition

As noted, one of the touchstones of both Treasury I and Reagan I, as well as other tax reform plans in Congress, is that they be revenue neutral, at least on paper. Reagan I already is getting criticism for possible overestimating of revenues through 1990. Longer term, concern has been expressed that the revenue balance of the program could turn more decidedly negative as some of the base-broadening moves are digested and the rate reductions take hold. The Administration's basic answer here seems to be: Don't worry, better growth from economic efficiencies will take care of it.

Of more pressing concern for the interim period is the effect on households and businesses of jamming through such major structural changes on January 1, 1986, or with relatively short phase-ins. One of the more troubling examples of this is the proposed repeal of the investment tax credit for property placed in service after January 1, 1986, without honoring binding contracts or firm commitments in the manner of the 1969 repeal. Congress tends to be more liberal on transition rules, and the Chairman of the Ways and Means Committee already has indicated that he intends to be so with respect to the investment credit. But if so, presumably there will have to be additional revenue pickup elsewhere.

The quick transitions in the Reagan I program are driven by the stated need to make the full rate reductions effective at one time. In fact, the proposed timing for the rate reductions is July 1, 1986, which saves money in fiscal 1986 but makes adjustment to base-broadening measures effective six months earlier even tougher.

Nobody knows how all of this would work out simply because we have not had to deal with it before, at least to the extent of the present proposals. We do know that the Treasury would have to increase its regulations writing capacity by a large factor. Even assuming it can work down the present large

backlog, the potential regulations projects under Reagan I are awesome to contemplate. Inevitably there will be serious dislocations and uncertainty for investors, businesses and their employees.

Policy Directions

Tax policy ala Reagan I appears to have distinctly different dimensions with respect to individuals and business. On the individual side, as a result of rate compression and base broadening, there is clear direction toward simplification, horizontal equity, and making taxes less important in the life of individuals as consumers and investors. The net benefit that most individuals would receive in dollar terms is not all that important for economic behavior but it may be for political acceptance of the program.

On the business side, the direction is much less certain. Reagan I is probably less divisive of the business community than Treasury I because some of the rough edges have been smoothed and the disparity of appeal between service and high-effective-rate businesses on the one hand and the capital intensive industries on the other is not quite so wide. The proposed corporate rate reduction, of course, would be substantial, and beneficial overall but significant tax burdens on the business sector are still proposed, and they would still affect mainly capital intensive business.

Treasury I would have had a unifying theme with respect to business taxation in the proposed spread of inflation indexing and theoretically, at least, better measurement of income and deductions. With the dropout of interest indexing a good part of that neat architectural arrangement is gone. So is the certainty with respect to capital recovery policy with a still quite drastic shift in the 1954-1981 trend in the works. Moreover, there are additional and troublesome new complexities proposed for business taxation in production cost accounting, in the treatment of foreign source income, for individual industry sectors and investments, and, yes, even for business entertainment. If you thought the three-martini lunch was a rallying cry only for the Carter Democrats, think again.

Finally, the reform plan does not seem to give serious weight to the problems of American business in a global context. There is virtually no mention of likely international consequences of the myriad provisions of Reagan I. It could be said that the lower tax rate structures would help make the U.S. an even more attractive place for foreign investment, both portfolio and direct investment that wouldn't require heavy capital outlays. But the cutbacks in capital cost recovery, particularly the repeal of the investment tax credit, certainly would not make it any easier for U.S. capital intensive industries to deal with increasingly stiff competition both in export markets and at home. The proposed changes in the taxation of foreign source income could put U.S. multinationals, whatever their product mix, at a competitive disadvantage vis-a-vis foreign competition in low-tax jurisdictions. The proposed treatment is much more restrictive than foreign companies face from their host governments. With the threat of a trade recession hanging over us, more attention should be paid to the impact of tax policy on the U.S. position in international trade and investment as tax reform is considered by Congress.

Individual Income Taxes Remain Chief \$ Source

Individual income taxes took in the big money for U.S. governments in fiscal year 1983 (latest data available). Such taxes furnished 29.1 cents out of every revenue dollar collected by Federal, state, and local governments, according to Tax Foundation researchers.

Next came social security payroll taxes (OASDHI), at 15.8 cents per dollar of total revenue; current charges and user fees, 9.6 cents; miscellaneous general revenue (interest earnings, special assessments, etc.), 8.5 cents; property taxes, 7.5 cents; selective sales and excises, 6.8 cents; general sales taxes, 5.5 cents; and corporate income taxes, 4.3 cents.

Revenue trends during the period since 1960 highlight a number of significant modifications in the way government programs are funded.

The role of taxes in financing government services has declined relative to nontaxes. Borrowed funds, not included in the "revenue" totals, now finance a bigger share of government than any single tax other than individual income and social security. (Continued on page 4)

How Federal, State, and Local Governments Raise Each Dollar of Public Funds Selected Fiscal Years 1960-1983

Source	Cents per dollar of total revenue			
	1960	1970	1980	1983
Tax revenues	82.7	82.4	78.2	74.3
Individual income	28.2	30.3	30.7	29.1
Social security (OASDHI)	7.0	11.5	15.0	15.8
Property	10.7	10.2	7.3	7.5
Selective sales and excises	12.5	9.8	6.5	6.8
Corporate income	14.8	11.0	8.4	4.3
General sales	3.5	4.8	5.5	5.5
Other taxes ^a	6.0	4.8	4.8	5.2
Nontax revenues	17.3	17.6	21.8	25.7
Current charges	8.1	7.9	8.6	9.6
Miscellaneous general revenue ^b	3.3	4.0	6.7	8.5
Employee retirement	1.9	2.5	3.1	4.0
Utilities and liquor stores	3.2	2.6	2.7	3.2
Other nontaxes	.8	.6	.7	.6

Exhibit (billions):

Total revenues	\$153.1	\$333.8	\$932.2	\$1,181.3
Surplus (+) or deficit (-)	+\$ 1.8	+\$.8	-\$ 26.5	-\$ 169.7

^aIncludes death and gift, motor vehicle and operators' license, unemployment compensation, and miscellaneous taxes.

^bIncludes interest earnings, special assessments, sale of property, and others.

Source: *Facts and Figures on Government Finance*, 1983, Tax Foundation, Incorporated; basic data from U.S. Department of Commerce, Bureau of the Census.

THE FRONT BURNER

By Robert C. Brown
President
Tax Foundation, Incorporated

"The Fiscal Shell Game"

The annual flimflam known as the budget debate is well underway at this writing. Given the growing pressure of the deficit, the Senate and House may be well on the way to passing their First Concurrent Budget Resolution by the time this issue of *Tax Features* arrives in the mail.

One thing is certain. Even if the much-vaunted \$56-billion savings cut survives the reconciliation process, it will be worth far less than the White House and the Congress would have us believe. It was never worth \$56 billion to begin with. \$35 billion is about all the real money that is involved in this debate.

What is at work here is a long-standing fiscal shell game. First, Administration and Congressional budget-makers choose the rosier assumptions available about the growth of the economy and the decline of interest rates. This means they can project higher tax revenues and lower interest payments on the staggering Federal debt.

Next, comes what can only be described as baseline bingo. The budgeteers shop around among projections by the Office of Management and Budget and the Congressional Budget Office concerning the costs of various Federal programs: defense, social welfare, agricultural, etc. They select levels of spending that would never have occurred, cut huge hunks of those paper outlays, shift costly items on or off budget at will, then claim massive cuts in outlays made at great personal pain.

This slight of hand fools no one in Washington. It fools fewer and fewer voters and taxpayers in the rest of the country. But, from a public relations perspective, it produces a win-win situation for virtually

everyone in the Executive and Legislative Branches.

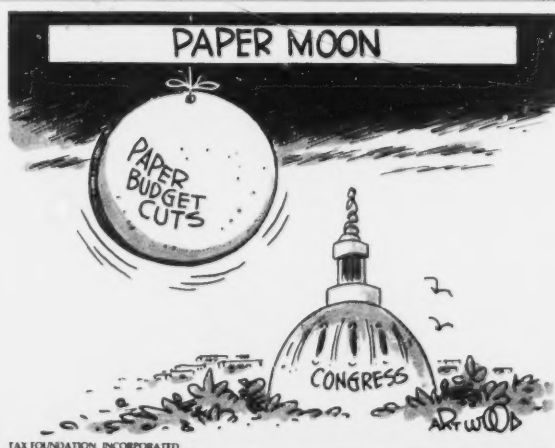
The White House is able to claim a responsible budget that moves the nation, if not toward budget balance, at least toward "reasonable" deficit levels by the end of the decade. Everyone in the Congress can send the next constituent newsletter to the folks back home painting their efforts in the best possible light.

Hawkish conservatives can claim they have kept a lid on runaway welfare spending. Dovish liberals claim they have taken a whack at the bloated Pentagon budget.

Meanwhile, Federal spending levels grow, the size of the net Federal tax take grows, and the national debt soars into the wild blue yonder.

Is it any wonder that our elected leaders are having a hard time interesting most of the populace in either deficit reduction or tax reform? As the old tune says, "It seems to me I've heard that song before."

"Even if the much-vaunted \$56-billion savings cut survives the reconciliation process, it will be worth far less than the White House and the Congress would have us believe."



TAX FOUNDATION, INCORPORATED

(INCOME SECURITY, from page 1)

dollar claim on the total in 1983 declined from 16.7 cents in 1970 and 15.0 cents in 1980.

The fastest growing cost of government in recent years has been interest on general debt, which rose from 6.2 cents per dollar in 1960 to 9.8 cents per dollar of total spending in 1983.

The four largest categories of spending—major social welfare, defense and international relations, education, and interest—accounted for a combined total of 73.5 cents per dollar of all spending in 1983, or \$11,834 per U.S. household.

The table below provides further details.

**How Federal, State, and Local Governments
Spend Each Dollar of Public Funds
Selected Fiscal Years 1960-1983**

Function	Cents per dollar of total spending			
	1960	1970	1980	1983
Major social welfare programs, total	20.6	25.8	33.6	33.7
Social security (OASDHI)	7.1	10.8	15.6	16.4
Social services and income maintenance ^a	8.5	10.7	13.0	12.7
Government employee retirement	1.4	1.9	3.0	3.0
Veterans (not elsewhere classified)	2.5	1.6	1.3	1.2
Railroad retirement	.6	.5	.5	.4
Veterans' life insurance	.4	.3	.1	.1
National defense and international relations	32.3	25.3	15.6	16.9
Education	12.8	16.7	15.0	13.1
Interest on general debt	6.2	5.5	7.9	9.8
Environment and housing	5.4	4.4	4.9	5.4
Utilities and liquor stores	3.4	2.8	3.8	3.9
Transportation	7.6	6.2	4.4	3.4
Public safety	1.8	2.0	2.3	2.3
Government administration	1.8	1.9	2.2	2.1
Postal service (Federal)	2.5	2.3	1.9	1.7
Sanitation	1.1	1.0	1.4	1.2
All other	4.5	6.1	7.0	6.5
Exhibit (billions):				
Total spending	\$151.3	\$333.0	\$958.7	\$1,351.0

^aIncludes public welfare, hospitals, health, and unemployment insurance benefits.
Source: Department of Commerce, Bureau of the Census; and Tax Foundation computations.

(GOVERNMENT SPENDING, from page 1)

In the past seven years, total government spending has more than doubled, rising from \$745.4 billion in 1978 to \$1,582.8 in 1985. Federal spending has risen by 115 percent, while state and local spending from their own sources has risen by 108 percent.

Total government expenditures moved up from 21.3 percent of GNP in 1950, to 26.9 percent in 1960, 31.6 percent in 1970, and 34.3 percent in 1984.

The state-local share of this spending has declined in relation to GNP, from 11.0 percent in 1970 to 10.3 percent in 1984. Federal outlays have risen from 20.6 percent of GNP in 1970 to 24.0 percent in 1984.

The table on page 1 provides further details.

(INDIVIDUAL INCOME TAXES, from page 3)

The share of taxes in the revenue dollar dropped from 82.7 cents in 1960 to 74.3 cents in 1983; nearly all of the reduction came after 1970.

Social security taxes, the fastest growing revenue source, have more than doubled their share in the total revenue system. In 1983 they were more than 17 times as large as they were in 1960.

The table on page 3 provides further details.

*(TOP EARNERS, from page 2)***The Payers**

Of the 1982 *taxable* returns in the \$200,000 and over group, three-fourths paid at an effective rate in excess of 20 percent in terms of expanded income and over one-third paid in excess of 35 percent. We use *effective* tax rates—total tax divided by total income—in these comparisons because they are appropriate for considering the distribution of tax burdens. Bear in mind, however, that the *marginal* tax rate—rate of tax paid on an additional dollar of income—is always much higher. For this level of income, marginal rates, which have a critical impact on work and savings incentives, uniformly would be at or close to 50 percent for Federal income tax.

Actual amounts of tax incurred by the high income group *averaged* \$138,500 in 1982 further indicating the substantial tax burden of upper income taxpayers. This pattern is confirmed by Tax Foundation annual compilations of the share of total Federal income tax paid by the top percentiles of income. (See May 1985 *Tax Features*.) And, oh yes, the Federal income tax is still progressive, too. Effective rates of tax show a fairly steep rise through the income brackets, at least as measured by adjusted gross income in 1983.

None of the foregoing, of course, is addressed to the undeniable opportunities that *all* income groups have to reduce or eliminate tax liability by reducing reported income above the line—that is, before adjusted gross income is defined. These opportunities include outright tax evasion and fraud—non-reporting of income, which is a major problem, but which no minimum tax or similar legislation is going to catch anyway. They include abusive tax shelters, designed to yield large writeoffs from income because of artificially inflated deductions or losses. The IRS, armed with new penalty rules, is waging an aggressive campaign against abusive shelters. There are legitimate partnership tax shelters and tax exempt income from municipal bonds and industrial revenue bonds. It would be possible, of course, for individuals with no earned income to have substantial investment income from municipals and pay no Federal tax. Tax exempt interest, however, cannot shelter earned income or other passive income from tax.

Whatever the shelter opportunities, it's apparent that high income individuals as a group do pay substantial tax burdens and those paying no or very little tax are a distinct minority. This does not answer all the questions raised about "horizontal equity" and by those urging a new minimum tax. But it does put them in perspective.

Fall Seminar Planned

A Tax Foundation Seminar on the tax treatment of retirement savings and fringe benefits will be held on **Wednesday, September 18, 1985, in Washington, D.C.**

Further details and reservation information will appear in *Tax Features* or call the Tax Foundation at 202/822-9050.

8/30/85 R9050-3 A

TAX·FEATURES

'81 Tax Cut and Slow Inflation Boost U.S. Family's Buying Power

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Power**

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The "prototypical" family—one earner, employed full-time year-round, married, with two dependent children—has nearly 4 percent more to spend in 1985 than it did in 1981, according to Tax Foundation economists. The U.S. family's purchasing power has risen for four years, after hitting a 10-year low in 1981.

Measured in constant 1985 dollars, the family's real income after direct Federal taxes has gone up by \$764 in the last four years, say researchers at the Washington-based tax watchdog organization. The upturn in real income followed six years of decline.

Because of the reductions in the Economic Recovery Tax Act of 1981 (ERTA) and the recent slowing in the rate of inflation, real purchasing power has risen each year since 1981. In sharp contrast to experience during the previous six years, Federal direct taxes for this family have risen by less than 4 percent a year since 1981, and consumer prices have gone up by only a bit more than 4 percent annually. At the same time, the family's nominal income has increased an average of 5 percent each year.

The gains to date, however, still leave the family's real after-tax income lower than it was 10 years ago. For the decade, inflation and Federal taxes have cut the family's purchasing power, measured in constant 1985 dollars, by \$2,535 or 10 percent.

From 1975 through 1981, inflation and rising Federal taxes slashed \$3,299 (in constant 1985 dollars), or 14 percent, from the buying power of this prototypical family. During those years, increases in Federal income and social security taxes averaged nearly 11 percent annually, inflation was climbing at the rate of 9 percent a year, and the workers' pre-tax nominal income was rising by 7 percent annually.

From 1975 to 1985, while pre-tax income was rising by 85 percent, from \$14,156 to \$26,153, direct Federal taxes were climbing by 114 percent, from \$1,997 to \$4,287. Income tax liabilities went from \$1,172 to \$2,443, an increase of \$1,271 or 108 percent. Social security taxes jumped from \$825 to \$1,844, or 124 percent, as increasing amounts of revenues were needed to pay for the higher benefits resulting from the indexing of those benefits to the Consumer Price Index (CPI) as well as the increase in the number of beneficiaries.

As a proportion of the family's income, direct Federal taxes ranged from a low of 14.1 percent in 1975 to a high of 17.2 percent in 1981. In 1985, these taxes are estimated to be 16.4 percent of the family's income.

While the rise in direct Federal taxes reduced the family's gain as measured in nominal dollars by \$2,290, its income gain, before taking inflation into account, was still \$9,707, or 80 percent for the 1975-1985 decade.

During those years, the price level, as measured by the CPI, more than doubled, bringing the purchasing power of each dollar down to 50 cents, measured in 1975 dollars. The combination of rising prices and a rising tax bite cut the purchasing power of the family 10 percent for the decade.

The table below provides further details on median family incomes before and after direct Federal taxes and inflation, for the years 1975 through 1985.

**Median Family Incomes Before and After
Direct Federal Taxes and Inflation**

Year	Median family income ^a	Direct Federal taxes			After-tax income	
		Income tax ^b	Social security	Total	Current dollars	1985 dollars ^c
1975	\$14,156	\$1,172	\$ 825	\$1,997	\$12,159	\$24,401
1976	15,016	1,388	878	2,266	12,750	24,194
1977	15,949	1,466	933	2,399	13,550	24,149
1978	17,318	1,717	1,048	2,765	14,553	24,094
1979	19,048	1,881	1,168	3,049	15,999	23,808
1980	20,586	2,143	1,262	3,405	17,181	22,521
1981	21,462	2,267	1,427	3,694	17,768	21,102
1982	23,036	2,342	1,543	3,885	19,151	21,429
1983	23,949	2,278	1,605	3,883	20,066	21,754
1984 ^d	25,026	2,330	1,677	4,007	21,019	21,856
1985 ^d	26,153	2,443	1,844	4,287	21,866	21,866

^aMedian income for all families with one earner employed full-time, year-round.

^bMarried couple filing joint return, two dependent children.

^cAdjusted by Consumer Price Index of the Bureau of Labor Statistics. Assumes 4% inflation in 1985.

^dEstimated by Tax Foundation.

Source: U.S. Department of Commerce, Bureau of the Census; U.S. Department of Labor, Bureau of Labor Statistics; Treasury Department, Internal Revenue Service; and Tax Foundation computations.

Tax Treatment of Retirement Savings

Tax Foundation will sponsor a seminar on the "Tax Treatment of Retirement Savings" on **Wednesday, September 18, 1985, at the Sheraton-Carlton Hotel in Washington, D.C.**

Analysts from Congress, the Treasury, and private industry will explore the implications of proposed changes on the U.S. retirement system, evaluate policies in the legislative package now taking shape in the House and Senate, and explore alternative methods for handling retirement benefits.

For further details and reservation information, please call the Tax Foundation at (202) 822-9050.

OECD Countries' Political and Economic Ties Do Not Mean Uniformity in Tax Policy Approaches

In spite of economic and political ties, the member nations of the Organization for Economic Cooperation and Development (OECD) display great disparity in their tax structures. In 1982, for example, the share of individual and corporate income taxes ranged from less than 20 percent of total taxes in France and Greece to 69 percent in New Zealand, 57 percent in Turkey, and more than 55 percent in Australia and Denmark. The high shares of income taxes are largely due to the absence of payroll taxes to support social security in the four nations relying most heavily on income taxes, according to Tax Foundation analysis.

On an unweighted average basis, income taxes furnish about 40 percent of taxes in the 23 OECD countries combined. The U.S. share—45 percent—puts this nation in seventh place.

For individual income taxes alone, France recorded the lowest share (13 percent) for an OECD member in 1982. At the other end, New Zealand attributed 61 percent of its tax collections to this source. Denmark as well raised more than half of its revenues from individual income levies. The United States ranked seventh among the member countries, at 38 percent.

Corporate profits tax levies also generate significant revenue contributions for some of the member countries. Japan raised nearly one-fifth of its 1982 receipts by taxing corporate incomes, ranking highest among the OECD nations by this measure. Seven percent of total tax receipts were derived from corporate income taxes in the United States in 1982. Denmark, by contrast, raised less than 3 percent of its revenue by taxing corporations.

Taxes on goods and services (sales or consumption levies) are second to income taxes as revenue raisers in all the OECD nations combined, providing an average of 29 percent of tax revenues. The United States—receiving only 17 percent of its receipts from such taxes—ranks 21st among the 23 members in its reliance on consumption levies. Only Japan (15 percent) and Italy (16 percent) derived a lesser proportion of total taxes from goods and services. Three major industrialized countries—France, Germany, and the United Kingdom—obtained 25-to-30 percent of tax receipts from consumption taxes.

Social security levies—payroll taxes—follow income and consumption taxes as major revenue sources for OECD countries, providing about 24 percent of all tax receipts on average. Variations from country to country, however, are significant. Australia and New Zealand,

for example, do not levy payroll taxes to support social security programs; and Denmark gets less than 3 percent of its tax revenues from such levies. In contrast, social security accounted for 47 percent of Italy's 1982 tax receipts; and for more than 40 percent of total tax revenues in France, Spain, and the Netherlands. The United States ranked near the middle (14th), getting 28 percent of its taxes from social security levies.

Property taxes generally are not a major source of tax revenues in OECD countries, providing an average of only 5 percent of total taxes. In 1982, the United Kingdom ranked first in its reliance on property taxes (13 percent of the total), followed by the United States (10 percent), and Canada (9 percent.)

Another way to compare tax systems among the major industrialized countries is to examine the size of their tax receipts in relation to economic production, as measured by gross domestic product (GDP).

By this standard, Sweden is the "most taxing" nation, receipts coming to just over 50 percent of GDP in 1982. Norway ranks second at 48 percent. U.S. taxes in 1982 came to 30 percent of GDP, placing this country 20th among its OECD affiliates. At the low end, Spain and Turkey raised taxes amounting to 25 and 20 percent of GDP, respectively.

A table furnishing complete details is available from the Tax Foundation.

"Taxes on goods and services are second to income taxes as revenue raisers in all the OECD nations combined, providing an average of 29 percent of tax revenues."

WORDS TO PONDER

"The budget stalemate seems hopeless—because we've lost our perspective. Government can survive without a budget agreement. Remember 1983. We were foundering, unable to pass a modest tax increase or a spending package. But spending was kept in relative check, and we came right back with a \$50 billion tax bill that passed last May (1984)."

Rep. Dan Rostenkowski
Chairman, House Ways
& Means Committee
National Press Club
July 30, 1985

EDITOR'S NOTE: Forget about 1983. Remember 1984.

Tax Features

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New Publication

"Memorandum on the Allocation of the Federal Tax Burden and Federal Grants-in-Aid by State, Fiscal Year 1984" is now available from the Tax Foundation's Public Information Department. This 10-page memorandum presents a state-by-state comparison of Federal grants-in-aid to state and local governments for fiscal year 1984 and the Federal tax burdens that support grants.

Single copies of the memorandum are available for \$4.00, plus \$1.00 postage and handling per order.

FEDERAL TAX POLICY MEMO

AUGUST 1985

Editor: Edward A. Sprague, Vice President—Tax and Economic Affairs

Business Tax Burdens

It was commonly observed in the aftermath of the 1981 tax bill (The Economic Recovery Tax Act—ERTA) that the Federal corporate income tax was dead; that no corporation with a half-awake tax accounting department would need to pay corporate income taxes. That was a wild exaggeration but Congress has been taking the charge to heart ever since. It already has taken back, of course, a lot of the 1981 tax benefits to the business sector. It pays close attention to each new "study" of effective corporate income tax rates and other materials purporting to show how slim the corporate share of taxes has become. Tax reforms pending before Congress would increase drastically the overall burden of corporate taxes, and even if these reforms do not advance, there are others waiting in the wings to stiffen the corporate minimum tax, to ensure that corporations pay their "fair share."

The reasons for the decline in overall corporate tax receipts as a percent of total Federal tax receipts have been fairly well documented. They include a long-term decline in corporate profits as a percent of national income, the relatively very fast growth in payroll taxes compared to all income taxes, and, yes, the special tax provisions such as the Accelerated Cost Recovery System (ACRS) and other provisions designed to spur corporate investment, exports, research and development and other activities.

More recently, the focus has turned on (1) the wide variation in corporate effective tax rates associated with investment in different industries and asset categories; and (2) the extent to which individual corporations with significant "economic income" manage to escape with little or no Federal tax liability. In the first category are all the recent critiques of ACRS based on hypothetical application of assumed discount and inflation rates to individual types of investments. Ignored in the process is the real world condition that firms must operate with a mix of assets both tangible and intangible, and that the possibility of a negative tax rate that might theoretically obtain from a firm's particular equipment investment, utilizing the investment tax credit and ACRS, is much more unlikely to apply to the firm as a whole. Nevertheless, say the critics, these analyses are important to show how far we have strayed from "tax neutrality."

The other type of effective rate study typically examines the financial reports of selected corporations or groups of corporations comparing book provision for taxes with reported income. These studies may or may not account properly for the effect of taxes paid to foreign countries, loss carryovers and other timing factors. However, their hallmark is selectivity, zeroing in on particular corporations which for one reason or another in any given period pay low or no effective rates of Federal income tax. These studies typically have been sponsored by individual Congressmen or advocacy groups calling for stiffer tax treatment of the corporate sector.

The measurement of effective rates of corporate income tax is a controversial exercise. The Treasury Department has attempted, on occasion, to provide an overall analysis and some methodology to account for accelerated depreciation and other timing differences, loss carryforwards, etc. The last such effort was released in 1978 and applied to 1972 data which, obviously, is now obsolete. The Treasury may have a potential disclosure problem in terms of releasing detailed industry-by-industry figures because in some cases, one company may dominate a category. But Treasury now appears reluctant to even approach the subject generally.

In this context, the Tax Foundation plans to renew its series of special reports on corporate tax burdens as well as tracking individual and total tax burdens, of course. We will approach the matter from several angles, but because of data and resource limitations, will confine the analysis to overall trends in the corporate sector.

We also must bear in mind that the ultimate burden or incidence of corporate taxes is always borne by people, not inanimate corporate structures. Investors, workers or consumers ultimately will bear the burden depending on the economic circumstances of the industry. Because the precise proportions are not known and the process is obscured from public view, the corporate income tax in particular is a hidden tax and, as such, always more susceptible to political manipulation. As long as Congress and the Administration insist on revenue counting and estimating procedures showing "individual effects" and "corporate effects," we are forced to go along with this terminology and the fiction of the corporate tax burden as an entity in itself.

All this is prelude to some overall figures and comments on the extent of corporate taxes as shown on the next page.

Commentary

The national income accounts series contains a broad measure of corporate profits (Column A) that result from current production of U.S. corporations. It includes net inflows of foreign earnings but excludes corporate capital gains and intercorporate dividends of domestic corporations. Depreciation allowances are calculated on the same basis as corporate tax return information. There are several differences in coverage and definition from net profits (receipts less deductions) reported in the IRS Statistics-of-Income. However, in most years the differences tend to offset each other and the two series run quite parallel in overall totals.

Conceptually, corporate profits tax accruals (Column B) should track more closely with budget receipts of corporate income taxes given today's full acceleration of corporate tax payments. However, the accrual figures do include earnings of the Federal Reserve System which are deposited in the U.S. Treas-

I—Federal Corporate Income Taxes National Income Accounts Series (1950-1984)

Year ^a	(A) Total Corporate Profits Before Tax (\$ bil.)	(B) Federal Corporate Income Tax Accruals (\$ bil.)	(C) Effective Rate of Federal Tax (B/A) (%)
1949-1950-1951	38.9	16.2	41.6
1954-1955-1956	45.8	19.6	42.8
1959-1960-1961	50.7	21.8	43.0
1964-1965-1966	75.6	28.8	38.1
1970 ^b	75.4	30.6	40.6
1971	86.6	33.5	38.7
1972	100.6	36.6	36.4
1973	125.6	43.3	34.5
1974	136.7	45.1	33.0
1975	132.1	43.6	33.0
1976	166.3	54.6	32.8
1977	194.7	61.6	31.6
1978	229.1	71.3	31.1
1979	252.7	74.2	29.4
1980	234.6	70.3	30.0
1981	221.2	65.7	29.7
1982	165.5	46.6	28.2
1983	203.2	59.8	29.4
1984	235.7	69.7	29.6

^aPeriods before 1970 are three-year averages to dilute effect of business cycle swings.

^bIncludes some effect from Vietnam period surcharge.

ury. On a fiscal year basis these earnings amounted to \$15.7 billion and \$14.5 billion, respectively, in 1984 and 1983, and their inclusion tends to inflate both the corporate tax accruals and raise the estimated effective corporate tax rate (Column C). For some years, however, budget receipts of corporate payments ran ahead of accruals anyway.

The national income accounts series does provide a consistent and reasonably accurate overview of corporate profits and their taxation in the overall economic context. It does show a downtrend in the effective rate of Federal corporate income tax since the 1960s, due mainly to the expanded investment credit and other special provisions (not reflecting depreciation provisions) but also indicates that the corporate income tax has been a significant factor right along.

While Federal corporate income taxes have risen a little over 50 percent in the last decade, state/local income taxes have jumped almost 200 percent and in 1984 amounted to over a quarter of the Federal levy. The combined Federal and state/local effective corporate income tax rate, therefore, showed a smaller dip in the 1970s and has risen slightly since 1979.

The largest element of the business tax burden, however, is now the payroll tax sector, particularly for Federal social secu-

rity and hospital insurance but also for state unemployment insurance and other social insurance funds. These taxes are not imposed on net income, and some economists argue that even the employer share of payroll taxes is borne by employees in lower-than-otherwise compensation. But payroll taxes are a cost of doing business and, particularly in labor-intensive industries, constitute a very large burden. Where labor is relatively scarce and/or subject to rigidities in compensation, that burden may be absorbed by the employer or the consumer.

In any event, the corporate share of payroll taxes has outstripped corporate income taxes decisively as of 1981, and will go well over \$100 billion this year. When the corporate share of payroll taxes is combined with corporate income taxes, they reached an amount equivalent to 85 percent of corporate profits in 1982 and only a little below that level in 1984 (Column G).

Even without considering some other major business taxes, such as the Federal windfall profits tax on petroleum and the very substantial state/local property taxes on business, it's apparent that the overall business tax burden is large and growing. It shows no sign of fading away despite special tax relief provisions of the last two decades.

II—State/Local Corporate Income Taxes and Corporate Payroll Taxes National Income Accounts Series (1972-1984)

Year	(D) State/Local Corp. Income Tax Accruals (\$ bil.)	(E) Effective Rate of Federal and State/Local Tax (B + D/A) (%)	(F) Corporate Payroll Taxes ^a (\$ bil.)	(G) Income and Payroll Taxes as % of Corp. Profits (B + D + F/A) (%)
1972	5.0	41.4	22.7	63.9
1973	5.8	39.1	30.0	63.0
1974	6.5	37.7	33.2	62.0
1975	7.1	38.4	33.7	63.9
1976	9.3	38.4	40.0	62.5
1977	11.1	37.3	45.6	57.2
1978	11.9	36.3	53.9	55.6
1979	13.4	34.7	62.5	59.4
1980	14.5	36.1	67.0	64.7
1981	15.4	36.7	77.7	71.8
1982	14.0	36.6	80.7	85.4
1983	16.0	37.3	88.0	80.6
1984	18.8	37.5	99.4 ^b	79.7

^aIncludes corporate employer share of OASDIH, state unemployment insurance tax, Federal unemployment tax, railroad unemployment insurance and retirement, and workers' compensation.

^bEstimated.

Sources for I and II: Economic Report of the President, various years, and unpublished statistics of the Bureau of Economic Analysis, Department of Commerce.

Per Capita Property Taxes Jump 40% from '76 to '83

Per capita property taxes in the major metropolitan areas of the nation vary widely in levels and rates of growth. Averaging \$440 per person in 1983, property taxes in the major Standard Metropolitan Statistical Areas (SMSAs) were 42 percent higher than in 1976.

All together, the 75 largest metropolitan areas get 38.9 percent of their general revenues from state and Federal governments and raise the remaining 61.1 percent from taxes and other sources. All taxes combined provide 40.8 percent of local general revenues; prop-

erty taxes alone make up 29.2 percent of local revenues, and 72.3 percent of locally raised taxes.

In ranking per capita property taxes in the largest 40 areas, Tax Foundation analysts note that the Nassau-Suffolk area in New York leads other places by a wide margin, with per capita property taxes in fiscal 1983 of \$944. It was followed by Newark, New Jersey (\$668); the New York-New Jersey area (\$625); Houston, Texas (\$616); and Detroit, Michigan (\$604). Other SMSAs in the top ten were: Boston (\$602); Hartford-New Bedford-Bristol, Connecticut (\$595); Milwaukee (\$566); the Washington, D.C.-Maryland-Virginia area (\$541); and Portland, Oregon (\$537).

Lowest per capita property taxes among the 40 largest areas were found in New Orleans, Louisiana
(Continued on page 4)

THE FRONT BURNER

By Robert C. Brown
President
Tax Foundation, Incorporated

"Apples and Oranges"

Two Martians landed their flying saucer in a field in the southwestern United States. They made their way into a country-western bar on the outskirts of a nearby town. Just inside the door, blaring and blinking for all it was worth, stood an elaborate juke box—a veritable carnival of flashing lights and sparkling chrome—pumping out a torrent of western music.

One of the Martians sidled up to the garish record player, winked each of his six eyes in succession, and said, "What's a nice girl like you doing in a place like this?"

Some of the elements in the current tax policy debate seem as out of place in the tax bill as Martians in a western saloon.

The assault on employee benefits is a good example, especially proposals that will undermine the personal capital formation options now available to American workers.

Ours is a redistributive income tax system, taking more from those who have enjoyed the benefits of the economy and transferring what has been collected to those farther down the economic scale. Within reasonable limits, this is laudable. However, one has to ask what sense it makes to deprive American workers of capital formation options in order to underwrite other provisions that are preferred by the current crop of tax writers. Is it sound policy to tax capital built up under annuity and whole-life insurance policies and discourage the popular 401K plans even if the laudable purpose of general rate reduction is said to be served by such "base broadening"?

Actually, a good many of the myriad changes proposed would have very little revenue impact. But they all would impact seriously the administration of all major types of retirement and benefit plans, affecting deductions and contributions, distributions, loans, anti-discrimination rules, plan terminations, contributory basis recovery, etc. The proposed anti-discrimination rules alone, in the name of uniform treatment of welfare and retirement plans, would threaten the continuation of some welfare plans even where benefit coverage is identical for all employees.

Undoubtedly some of the proposed changes have

merit from a reform viewpoint. But they would amount to another whole ERISA (Employee Retirement Income Security Act of 1974) hooked on to even larger tax revision. It took years to enact ERISA because of the complexity of the issues involved and now we are trying to redo it in a few months. How much reform can we stomach at one time?

Major labor relations questions are at stake. So are decisions about who shall care for aging Americans and their survivors, how that care is to be paid for. Finally, there is the over-riding consideration that the individual ought to be free to decide what kinds of future security he needs, wants, and is willing to pay for.

These issues, however, are not close to everyone's heart. Big taxers don't like them. Advocates of government as Big Brother don't like them. Those who seek to impose stifling rules on private sector initiative in the name of "uniformity" don't like them.

That's what's really behind the drive to finesse some very major policy changes through a Congress desperately looking for ways to appear to be doing something serious about tax reform and deficit reduction. That's why it's important for those who see what is really happening to raise their voices against mixing the apples of policy shifts with the oranges of tax reform—real or imaginary. The retirement income proposals should be split off from tax reform and considered separately and more deliberately at another time.

"One has to ask what sense it makes to deprive American workers of capital formation options in order to underwrite other provisions that are preferred by the current crop of tax writers."

"I'M NOT SURE I WANT IT."



TAX FOUNDATION, INCORPORATED

(PROPERTY TAXES, from page 3)

(\$164); San Antonio, Texas (\$238); Seattle (\$266); Phoenix (\$276); Tampa-St. Petersburg (\$294); and Sacramento (\$297). Following closely were St. Louis (\$300); Columbus, Ohio (\$302); and Baltimore (\$303).

Areas most heavily dependent on property taxes as a source of local revenues tend to have the highest levels of per capita property taxes, according to Tax Foundation analysts, although the correlation is not perfect. The Hartford area in Connecticut had the highest dependency ratio, receiving 55.7 percent of its revenues from property taxes; its per capita ranking was seventh. Nassau-Suffolk, with the second highest dependency ratio of 49.3 percent, ranked first in per capita levels. Other areas with high scores on dependency and high rankings in per capita levels were Newark, Boston, Houston, Detroit, Portland, Chicago, and Milwaukee. On the other hand, the Dallas-Fort Worth area ranked tenth in the extent to which it depends on

property taxes as a revenue source, but fell 18th in per capita levels. New York-New Jersey, 29th in dependency ratio, was third from the highest in level; and the Washington, D.C. area, 23rd in its dependency ratio, stood ninth in per capita property tax level.

The seven-year trend in property tax levels shows the profound effects of Proposition 13 on the seven California areas that are among the nation's top 40 in population size. All seven of the California areas except Anaheim were paying lower per capita property taxes in 1983 than in 1976. In contrast, the areas outside California all reported increases.

In areas outside California, the 1976-83 increases ranged from lows of 25 percent in Boston and 27 percent in Phoenix to 115 percent in Houston, 99 percent in Pittsburgh, 98 percent in Fort Lauderdale, 92 percent in Tampa-St. Petersburg, and 90 percent in the Washington, D.C. area.

The table below provides details.

**Per Capita Local Property Taxes in Relation to Total Local Revenues
All Local Governments in Selected Standard Metropolitan Statistical Areas
Fiscal Years 1976 and 1983**

Area ^b	Per capita property tax			Property tax as a percent of local revenue ^c —1983	
	Amount	Percent change	Rank ^c	Percent	Rank ^c
	1976	1983			
Total, 75 major SMSAs	\$310	\$440	+ 42	29.5	
Anaheim-Santa Ana-Garden Grove, California	366	395	+ 8	29.0	18
Atlanta, Georgia	256	411	+ 61	28.4	20
Baltimore, Maryland	196	303	+ 55	22.9	30
Boston, Massachusetts	483	602	+ 25	43.3	4
Buffalo, New York	307	468	+ 52	27.9	22
Chicago, Illinois	319	531	+ 66	37.2	8
Cincinnati, Ohio-Kentucky-Indiana	197	317	+ 61	28.2	21
Cleveland, Ohio	286	405	+ 42	25.9	25
Columbus, Ohio	193	302	+ 56	25.5	27
Dallas-Fort Worth, Texas	247	419	+ 70	33.4	10
Denver-Boulder, Colorado	284	443	+ 56	28.7	19
Detroit, Michigan	352	604	+ 72	40.7	6
Fort Lauderdale-Hollywood, Florida	223	442	+ 98	31.6	12
Hartford-New Britain-Bristol, Connecticut	383	595	+ 55	55.7	1
Houston, Texas	286	616	+ 115	41.0	5
Indianapolis, Indiana	253	343	+ 36	31.5	13
Kansas City, Missouri-Kansas	241	310	+ 29	25.6	26
Los Angeles-Long Beach, California	419	314	- 25	18.6	36
Miami, Florida	245	438	+ 79	26.9	24
Milwaukee, Wisconsin	331	566	+ 71	34.2	9
Minneapolis-St. Paul, Minnesota-Wisconsin	316	491	+ 55	29.5	16
Nassau-Suffolk, New York	609	944	+ 55	49.3	2
Newark, New Jersey	493	668	+ 35	44.3	3
New Orleans, Louisiana	93	164	+ 76	12.8	40
New York, New York-New Jersey	438	625	+ 43	24.3	29
Philadelphia, Pennsylvania-New Jersey	237	392	+ 65	29.1	17
Phoenix, Arizona	218	276	+ 27	17.5	39
Pittsburgh, Pennsylvania	199	397	+ 99	31.4	14
Portland, Oregon-Washington	328	537	+ 64	37.5	7
Riverside-San Bernardino-Ontario, California	352	316	- 10	19.3	35
Rochester, New York	328	525	+ 60	32.6	31
Sacramento, California	333	297	- 11	18.4	37
St. Louis, Missouri-Illinois	228	300	+ 32	29.7	15
San Antonio, Texas	148	238	+ 61	22.6	31
San Diego, California	341	320	- 6	20.9	33
San Francisco-Oakland, California	493	389	- 21	20.1	34
San Jose, California	435	392	- 10	22.5	32
Seattle-Everett, Washington	193	266	+ 38	18.3	38
Tampa-St. Petersburg, Florida	153	294	+ 92	25.2	28
Washington, D.C.-Maryland-Virginia	285	541	+ 90	27.1	23

^aGeneral revenues only; excludes revenues for insurance trust operations.

^bThese are the 40 most populous Standard Metropolitan Statistical Areas according to estimated population as of April 1, 1980, and contain 11,600 local governments.

^cRank among 40 most populous areas.

Source: Department of Commerce, Bureau of the Census; and Tax Foundation computations.

"Areas most heavily dependent on property taxes as a source of local revenues tend to have the highest levels of per capita property taxes."